

# **The Stahl Plan**

*A Proposed Revision of HR 3997*

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# Objective

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- The objective of this proposal is to provide Congress with a market-based solution that relies on private, rather than taxpayer, capital to improve the functioning of the credit markets, relieves the Government of the risk of trying to establish clearing prices, and also generates significant tax revenue for redeployment. It uses the power of the U.S. Federal Government to orchestrate some modest regulatory changes.
- The principal elements of The Stahl Plan are as follows:
  1. **Value Enhancement** – In exchange for the voluntary extension of loan maturities by lenders, Congress authorizes that interest paid on such loans be tax exempt for the duration of the extension. It would provide:
    - a. Immediate liquidity to borrowers without using Federal funds, by reducing monthly payments.
    - b. Increased loan values and bank capital, since maturity extensions and tax exemption have quantifiable value.
  2. **Liquidity Mechanism** – Congress authorizes the placement of ‘toxic’ assets into government sponsored exchange traded funds (ETFs) which would trade on major stock exchanges. This would:
    - a. Establish liquidity for assets now immobilized on bank balance sheets via a well-understood, regulated mechanism.
    - b. Enable private capital rather than the government to establish the appropriate clearing prices.
  3. **Revenue Enhancement** – The Government would levy income taxes on the ETF interest income, as well as an ongoing facilitation fee and one-time conversion fee for any appreciation in such ETFs.
    - a. Revenue enhancement to the Treasury would be several percent for each loan contributed to an ETF. This is simply a function of shifting from banks to the public market income that is shielded from taxation via the subsidized interest expense deduction.

The attributes of tax exemption and loan extension, public access and liquidity would all serve to raise the trading prices of these assets, permitting a passive restoration of bank capital via *write-ups*, and enable Congress to answer critics’ assertions that the stimulus programs incorporate excessive government intervention in the free markets. Further, while assisting financial institutions to deleverage, *increases* Treasury Dept. revenue by exposing more net interest income to taxation.

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# The Stahl Plan – Narrative Description

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## I. Establishment of a Framework for Price Discovery

The object of the \$700 billion funding allotment is to raise the market value of troubled assets now immobilized on bank balance sheets and thereby restore the banks to a properly capitalized status. However, the Rescue Bill has been represented in the popular media and in Congressional discourse as placing \$700 billion of taxpayer funds at risk. Fortunately, the funding requirement can be avoided, and the objective of the bill achieved, simply by re-packaging the troubled securities in the form of Exchange Traded Funds (ETFs).

Instead of direct expenditure, though, Congress could place a merely sufficient sum, say \$4 billion, of randomly selected primarily performing securitized loans into a series of ETFs to be listed on organized exchanges. Firms with related expertise would manage these ETFs on behalf of the U.S., subject only to the constraint that the portfolios consist of either the newly created exchange traded fund assets or fixed income vehicles issued by agencies such as Fannie Mae and Freddie Mac.

This would have the advantage of placing into the public domain a sufficient quantity of asset-backed securities to be open to broad scrutiny from regulators, the investment community and public.

It should be observed that even genuinely AAA sub-prime paper presently trades at approximately 50 cents on the dollar, with yields to maturity of nearly 15%. This preposterously low trading level is partly attributable to an illiquidity discount, these assets being non-tradable, since the entire mortgage-backed securities

market is frozen. The establishment of publicly traded diversified vehicles with such high yields to maturity would naturally invite the interest of broad segments of the global investment community.

The object of regulation should be to enable the market mechanism to function. One of the period's great ironies is that Lehman Brothers found itself unable to sell even AAA-rated mortgage-backed paper, yet its stock, irrespective of the price level, never stopped trading. In order for the capital markets to properly function, an orderly venue for the exchange of securities must be established. Once all participants understand the rules, the market mechanism will work, as is evident from scrutiny of the continuous trading market of the equities of those companies that find themselves unable to sell any type of fixed income paper.

## II. Value Enhancement

The obvious deficiency of the ETF mechanism alone is that many months will be required in order to orchestrate the construction and listing of suitable ETFs comprised of Mortgage-Backed Securities held by banks.

In order to solve the timeline problem, the U.S. Treasury, with the approval of Congress, should undertake to grant tax-exempt status to the interest income from any short-term debt instrument for which the creditor voluntarily undertakes to modify the terms to reduce the interest burden or extend the time of principal payment. There should be a minimum level of modification or extension that should serve as a tax exemption qualification.

# The Stahl Plan – Narrative Description

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Such exemption should be made renewable at the option of the creditor, provided that the debtor is given additional principal payment extensions. For reasons discussed below, this program should lapse at the end of five years.

In order to provide a transition period, the mark-to-market accounting rule otherwise known as FAS 157 should be temporarily suspended until such time as a viable public market has been established with proper price discovery. Since the cash flows of these assets would imply much better pricing than the mark-to-market models, capital market stability would follow.

The purpose of this program is two-fold. First, it provides immediate, direct liquidity relief to the borrower without the issuance of more money, lessening the liquidity pressure on short-term borrowers.

Second, it immediately increases the market value of existing short-term debt, all else equal, that voluntarily participates in the program. The increased values would necessarily be reflected in the quarterly bank mark-to-market and thus, given the existing financial leverage of the banks, the higher market values of such newly tax-exempt debt instruments would increase shareholders' equity.

Private capital would now have a powerful incentive to purchase loans, since loan term modification should probably result in value enhancement. This would mobilize capital from all areas of the globe to invest in loans.

### III. Expansion of the Loan Market

Further conversions of mortgage-backed securities into ETFs could be overseen by the banking industry under the auspices of a newly created ETF Committee, supervised by the Secretary of the Treasury and the Chairman of the Securities and Exchange Commission. As assets are packaged into ETFs, a given bank will simply receive, in exchange for the assets, units of the Fund. If the banks require liquidity, they could then sell these units in the global marketplace.

Another approach to enhance the value of these measures would be to permit managers selected to manage the Treasury program to invite their existing client base or new clients to pool private capital with the Treasury program. In this scenario, once a market is established, the newly tradable mortgage-backed paper in ETF form might well be attractive to the outside capital of the world and, if this is so, a liquid market might be created without very much further participation by the United States government.

### IV. Federal Conversion Authority

However, participation in the program should be subject to Treasury Department approval. The creation of enormous amounts of paper of this type can easily become problematic from a Treasury revenue perspective. Moreover, this could, if uncontrolled, become problematic for existing issuers of tax-exempt paper inasmuch as it could provide competition.

In order to address the second problem, the modifications of loan terms should be limited to a five year period. Therefore, no long-term paper would be created.

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# The Stahl Plan – Narrative Description

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The prices at which banks would sell loans would be made available in the form of a database maintained by the Treasury Department. It should be specifically unlawful to engage in the purchase or sale of any loan without reporting such transaction to the appropriate US Treasury authority.

As private capital is attracted to the loan marketplace and loan conversion and modifications occur, the federal government should permit the registration of more ETFs to which loan market participants can sell loans. A fund can purchase a modified loan or purchase a loan in its original format. A loan cannot be modified more than once and participate in this program. A modified loan that has become tax-exempt should not be held in the same portfolio as an unmodified loan. This will better enable the market to create bona fide price discovery for loans in modified and unmodified status.

As the publicly traded loan market expands, more specialized funds will probably be created with specific loan criteria that should enable better price discovery.

## V. U.S. Treasury Revenue

Each ETF, so structured, should charge an appropriate administrative fee, which should be remitted to the U.S. Treasury so that the public may benefit from the assistance rendered to the private financial sector. Since the standard life of a mortgage is measured in decades, this would ensure a steady stream of income to the U.S. government for many years to come.

Further, upon the expiration of the tax-exemption period for such loans, the income taxes on the ETF interest income would provide

substantial tax revenue to the Treasury. This could exceed by several hundred percent the tax revenue collected upon the same loans when held on bank balance sheets. The reason for this is that a normalized bank net margin on, let us say, a 6% average gross yield on loans, might be only 1% after deducting cost of funds as well as administrative expenses and loan losses.

In essence, the tax system subsidizes bank leverage via the interest expense deduction, so that only a small fraction of gross interest income is exposed to taxation. Within the ETF, the same loans would be subject predominantly to the administrative expense, such that perhaps 5% points of net income are exposed to taxes.

For example, if \$1 trillion of mortgages were securitized in this fashion, and the U.S. Government were to actually receive a 35 basis points facilitation fee and, upon expiration of tax exemption, a 35% income tax, the annual tax revenue would amount to \$21 billion, or \$4 billion per annum, as a revenue source. The \$700 billion outlay would be avoided and the people would enjoy an ongoing revenue stream.

## VI. Ancillary Benefits

This plan would create other benefits as well. An entirely new segment of the financial services industry, which would necessarily employ many people and create much needed revenue for the United States Treasury, would evolve.

In such an instance, the U.S. government would have, by investing its initial capital, started a new branch of the investment

# The Stahl Plan – Narrative Description

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management industry. The government should, under such circumstances, retain a five-basis-point carry. In this aspect of the newly created money management program, the funds generated by this action for the credit of the United States might well be used to fund health insurance subsidy payments or other social programs.

More importantly, it would also diminish the likelihood of future financial crises. The Conversion Authority would place in the hands of the FDIC an important tool to assure bank capital adequacy, because it could not merely require a bank to deleverage, but actually have at its disposal an enabling mechanism, apart from seizure of the institution.

At present, a regulatory authority that wished a bank to deleverage would probably need to forbid it from making new loans, or perhaps engage in the trauma of an FDIC takeover or forced merger with a larger institution. The ETF mechanism, as a practical matter, restores bank access to capital so that a given bank is not totally dependent upon its ability to fund. A bank could always sell its fund units or create new units by conversion of mortgages to units. A bank could gradually deleverage in an orderly manner if required to do so by a regulatory authority. If the ETF market were sufficiently deep and rich, in principle, a bank could deleverage in a matter of days. This could even be accomplished gradually if this were to be a more desirable course of action.

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# The Stahl Plan – Proposed Actions

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## Proposed Revision of HR 3997

### Proposed Action Set I – Creation of a Liquid Market for Level III Assets

1. Congress shall appropriate for the use of, and at the discretion of, the Secretary of the Treasury a random selection of \$4 billion of Level III assets.
  2. The Level III assets would be then segregated into a series of six pools structured along the lines of the well-known ABX indices (e.g., AAA, AA, A, BBB, etc.).
  3. The pools would be converted into Exchange Traded Funds and be listed on organized exchanges.
  4. The Treasury Secretary will engage the services of ten respected managers with expertise in areas such as Mortgage-Backed Securities.
  5. The Treasury Department will award each of the ten managers the mandate to manage these assets on behalf of the United States. On the day of establishment, each manager would be given an identical portfolio composed of the aforementioned ETF assets. The managers would be free to alter their portfolios as desired subject only to the constraint that the portfolios consist of either the newly created ETF assets or fixed income vehicles issued by agencies such as Fannie Mae and Freddie Mac.
  6. This would have the advantage of placing into the public domain a random cross section of Level III assets that would receive broad investment as well as public scrutiny.
  6. The Securities and Exchange Commission should be empowered to enforce rather rigorous disclosure requirements about these ETFs. This will permit proper assessment of the underlying securities, since the essential object of a public listing of such paper is to attract and mobilize global capital.
  7. The banking industry should establish an ETF committee under the supervision of the Secretary of the Treasury and the Chairman of the Securities and Exchange Commission. The object of the committee will be to select further quantities of Level III assets to be packaged into ETFs. As Level III assets are packaged into ETFs, a given bank will simply receive, in exchange for Level III assets, units of the Fund. If the banks require liquidity, they could sell these units in the global marketplace. The actual sale of fund units should, as a generalization, be left to the discretion of the individual banks.
  8. Each Exchange Traded Fund, so structured, should charge an appropriate administrative fee, the level of fees to be determined by the Treasury Department.
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# The Stahl Plan – Proposed Actions

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9. In order to provide a transition period the mark-to-market accounting rule otherwise known as FAS 157 should be temporarily suspended until such time as the Treasury Department, in consultation with the SEC, determines that a viable public market has been established with proper price discovery.

## **Proposed Action Set II – Creating Near-Term Borrower Liquidity and Value Enhancement for Level III Assets**

10. In order to provide immediate liquidity and valuation benefits during the months that will be required to orchestrate the construction and listing of suitable Level III-based ETFs, the U.S. Treasury, with the approval of Congress, should undertake to grant tax-exempt status to any short-term debt instrument for which the creditor voluntarily undertakes to grant the debtor a thirty-day extension of principal payment.

During the extension period, interest derived from those debt instruments will be tax-exempt. Such tax exemption should be made renewable at the option of the creditor, provided that the debtor is given the additional thirty-day principal payment extensions.

11. This program should lapse at the end of five years, so as to avoid crowding out effects in the municipal tax-exempt paper market.
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**The Stahl Plan - U.S. Treasury Revenue Benefit Exercise**

	Mortgage-Backed Securities Held On Balance Sheet	Mortgage-Backed Securities Held In ETFs
Interest	6.00%	6.00%
- Cost of Funds	3.00%	0.00%
- Allowance for Loan Losses	1.00%	0.00%
<u>- Administration Expense</u>	<u>1.00%</u>	<u>0.75%</u>
Net Interest	1.00%	5.25%
Corporate Tax Rate	35.00%	0.00%
Corporate Tax Rate Post-Tax-Exemption Period	35.00%	35.00%
<b>Net Tax &amp; Fees</b>		
Net Tax	0.35%	0.00%
Net Tax Post-Tax-Exemption Period	0.35%	1.84%
Conversion Fee	0.00%	20.00%
Facilitation Fee	0.00%	0.35%
Par Value	100,000	100,000
Principal @ t <sub>0</sub>	50,000	50,000
Principal @ t <sub>1</sub>	<u>50,000</u>	<u>80,000</u>
Principal Appreciation	0.00	30,000
<b>Net Tax Income &amp; Fee Income</b>		
Net Tax Income	350.00	0.00
Net Tax Income Post-Tax-Exemption Period	350.00	1,837.50
Conversion Fee	0.00	6,000.00
Facilitation Fee	0.00	280.00

Currently, by holding mortgage-backed securities on the balance sheets of banks, the majority of mortgage interest income is shielded from taxation due to various expenses and deductions, primarily interest expense from borrowings, as well as overhead and allowances for loan losses. If these assets were transferred to exchange-traded funds (ETFs), the majority of interest income would be subject to taxation, shown here as Net Interest.

The Stahl Plan calls for all interest payments to be deemed tax-exempt for a period equal to the duration of the loan extension. In this example, ten years is used as the extension.

In addition to calling for tax exemption for the duration of the loan extension, The Stahl Plan suggests that both a conversion and facilitation fee be charged. In this example, a one-time conversion fee of 20% is levied against any increase in value after the mortgage-backed securities are placed in an ETF. Additionally, a facilitation fee of 35 basis points is to be charged against the total asset value of the ETFs annually for the life of the funds.

In this example, it is assumed that after extending the maturity date by 10 years, deeming all interest income tax-exempt for 10 years, and placing the assets in an ETF, the value increases from \$50,000 to \$80,000.

For the purposes of calculating a facilitation fee, it is assumed that the fund trades at \$80,000 for the life of the fund. The facilitation fee, then, is simply 0.35% multiplied by \$80,000. The conversion fee is 20% multiplied by \$30,000 and the Net Tax Income Post-Tax-Exemption Period is 1.84% [5.25% income x 35% tax rate] multiplied by \$100,000.

	Annual Government Tax Revenue Mortgage-Backed Securities Held On Balance Sheet	Mortgage-Backed Securities Held In ETFs
Year		
1	350.00	6,280.00
2	350.00	280.00
3	350.00	280.00
4	350.00	280.00
5	350.00	280.00
6	350.00	280.00
7	350.00	280.00
8	350.00	280.00
9	350.00	280.00
10	350.00	280.00
11	350.00	2,117.50
12	350.00	2,117.50
13	350.00	2,117.50
14	350.00	2,117.50
15	350.00	2,117.50
:	:	:
:	:	:
30	350.00	2,117.50
31	0.00	2,117.50
32	0.00	2,117.50
33	0.00	2,117.50
34	0.00	2,117.50
35	0.00	2,117.50
36	0.00	2,117.50
37	0.00	2,117.50
38	0.00	2,117.50
39	0.00	2,117.50
40	0.00	2,117.50

**Mortgage-Backed Securities Held On Balance Sheet:**  
In this scenario, each year's tax revenue is simply 0.35% multiplied by the par value of the loan, which in this case is \$100,000. As a result, the tax collected over the course of the 30 year mortgage is \$10,500.

**Mortgage-Backed Securities Held In Exchange-Traded Funds:**  
In Year 1, the tax revenue collected is simply the conversion fee of \$6,000 and the facilitation fee of \$280. In years 2 through 10, the annual tax revenue is the facilitation fee of \$280 as a result of all interest income being tax-exempt for the 10-year forbearance period. In years 11 through 40, the annual tax revenue is the Net Tax Income Post-Tax-Exemption Period of \$1,837.50 and the facilitation fee of \$280.

**Multiple of Expansion of Government Tax Revenue:**  
As a result of this new source of tax revenue, total government tax revenue over the 40 year term expands from \$10,500 to \$72,325, a multiple of expansion of nearly 7 times.

**Total Government Tax Revenue**      **10,500.00**      **72,325.00**

**Multiple of Expansion in Government Tax Revenue**      **6.89 X**

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