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Statement No. 252

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Statement of the Shadow Financial Regulatory Committee on

**Doubts about the Master Liquidity Enhancement Conduit (M-
LEC)**

December 10, 2007

With the encouragement of the US Treasury three leading participants in the mortgage-backed securitization market – Bank of America, Citibank and JP Morgan Chase – have launched a Master Liquidity Enhancement Conduit (M-LEC) to attempt to deal with the liquidity problems of several Structured Investment Vehicles (SIVs). The M-LEC will stand ready to buy from SIVs in stress, their best quality assets over a period of one year. The M-LEC will be funded by issuance of commercial paper and capital notes and supported by a liquidity facility from the three sponsoring banks. Syndication for the new vehicle will be launched today, December 10, 2007.

The purported purpose of the M-LEC is to help restore orderly markets for asset-backed commercial paper. It is intended to relieve liquidity pressures on troubled SIVs by giving them the option to sell highly-rated assets to the M-LEC at a price determined by the advisor, Black Rock, rather than to sustain possible fire-sale losses by selling assets in the general market.

The designers of the M-LEC hope that these transactions will serve as an indication of the market values of similar securities that are held by a wide range of institutions including some money market mutual funds and thus provide an alternative to the prices inferred from derivatives that imply substantial markdowns in the fair values of even

some highly-rated tranches of sub-prime mortgage-related debt. Uncertainty about the accuracy of ratings of mortgage-related securitized debt led to a collapse of the secondary market for such debt in August and it has not yet recovered. The uncertainty has been exacerbated by the lack of clarity regarding the allocation of losses associated with this debt and a consequently heightened sense of counterparty risk. Sponsors of these securitization vehicles have dealt with this problem in several ways. In some cases they have purchased commercial paper that could not be easily rolled over and in others they have bought assets from the distressed securitization vehicles. At least one SIV has been unwound and three have been brought onto the balance sheets of sponsoring banks.

Banks are reluctant to bring these troubled assets onto their balance sheets for three reasons. First, this solution will increase the sponsoring bank's risk of loss and increase its regulatory capital requirements. Second, it raises troubling questions about whether the securitization vehicles were truly independent entities that need not have been included in the bank's risk disclosures from the outset. And third, it highlights the issue of whether reputation risk is properly taken into account in capital adequacy standards.

Historically, during crises, financial institutions have sometimes successfully acted in concert to create mechanisms that enhance price discovery by making markets in each others' claims. Thus, the idea of organizing collective action to aid price discovery for the senior tranches of mortgage-backed securities could help restore orderly market conditions. However, the test of any successful implementation of such collective action in facilitating price discovery would be the participation of independent, third parties in actual arm's-length market trading, and the information revealed by such a mechanism would be the prices observed in actual such trades between insiders and disinterested third parties.

Unfortunately, the implementation of this idea through M-LEC apparently would determine prices on the basis of estimates made by an independent advisor, Black Rock (in which Merrill Lynch owns a controlling share), rather than by generating observable, bona fide, arms-length market transactions. We would also note that banks and asset managers who hold these and similar securities would stand to gain from an optimistic view of prices. The strong reputation of Black Rock notwithstanding, we are skeptical that the prices generated through this process would be accurate or provide a credible basis for marking positions to market. To the extent that this delays the price discovery process, it will contribute to the uncertainty about the allocation of losses in these markets and continue the heightened sense of counterparty risk that is so destructive to the revival of markets.

We also note that an unintended consequence of removing the highest quality assets from these troubled securitization vehicles could be to reduce the willingness of holders of existing claims on these vehicles to roll them over when they mature. This problem has been widely discussed in the literature on lender of last resort intervention to assist depository institutions. An example of this problem is discussed in the accompanying Statement 251.