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4-1-2009

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Recommended Citation
Ettlinger, Michael; Jakabovics, Andrew; and Min, David, "Recommendations for the Public-Private Investment Program: Implementing the Treasury Department's Plan to Clean Up the Toxic Asset Mess" (2009). *YPFS Documents (Series 1)*. 8282.
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Recommendations for the Public-Private Investment Program

Implementing the Treasury Department's Plan to Clean up the Toxic Asset Mess

Michael Ettlinger, Andrew Jakabovics, and David Min April 2009

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Introduction and Summary

The U.S. Treasury Department's Public-Private Investment Program unveiled on March 23 will—it is hoped—finally solve the problem of "toxic assets" held by banks. These mortgage loans, mortgage-backed securities, collateralized debt obligations, asset-backed securities, exotic credit derivatives, and other credit instruments have significantly deteriorated in value over the past two years due to poor underwriting and weak economic conditions. This has left holders of these assets, including our nation's largest financial institutions, teetering on the brink.

The nation needs healthy financial institutions performing their much-needed role in the economy as providers of credit, and for that to happen these bad assets must be dealt with. The Treasury's PPIP plan—pronounced "Pee-Pip" in the corridors of finance in Washington and Wall Street— is the Obama administration's effort to address this problem after the stumbling attempts of the Bush administration.

A major obstacle to dealing with the toxic asset problem is how to determine what these assets are worth. How much value these assets have actually lost is a question of much debate. And devising a mechanism for ascertaining the correct prices is no easy task. The challenge is rooted in the murkiness surrounding these toxic assets. In the case of mortgages, the quality of the underwriting can be unknown and the future of the housing market and the length and depth of the recession certainly are. The same problems plague securities created from these mortgages, but it is even worse for these securities because of the more complicated nature of their relationship with the value of the underlying assets.

PPIP is designed to finally get the value of these assets right by creating a well-functioning market where buyers and sellers set prices through their transactions. This will in theory establish where the banks stand through a combination of getting the assets off their books through the market and providing a sound basis for setting the value of the assets they retain.

Although the Treasury has announced the general structure of PPIP, there are still a number of details to be fleshed out. Of utmost importance is addressing how the program will interact with the administration's efforts to address the housing crisis. PPIP has the potential for undermining those efforts if not implemented with this concern in mind. In addition, there are a number of aspects of implementation—including which institutions

are allowed to participate, the availability of information regarding transactions under the program, and performance metrics—which could have an important affect on investor and public confidence in the program and, ultimately, its effectiveness.

PPIP is designed to address the toxic asset issue by creating public-private partnerships that allow the cash-strapped private sector to participate in the marketplace for these so-called "legacy" assets—the term used by Treasury for toxic mortgages and securities—thereby resolving the question of pricing by establishing demand for the assets of which there is all too much supply. Whether PPIP will succeed remains to be seen. Because the program is a partnership with the private sector much depends on how the private sector responds, something that cannot be predicted with certainty. And how taxpayers fare with the program—which puts great sums of taxpayer dollars at risk while also offering opportunity for gain—depends on how the private market prices these assets and the future of the housing market and the economy in general.

If Treasury addresses a number of key issues still to be resolved, we believe that PPIP has a better chance of delivering on its promise to protect taxpayers, resolve the toxic assets problem, rebuild credit markets, and help the economy recover from the recession which began in December 2007. As implementation of PPIP proceeds, we believe it is important that the administration:

- Ensures moving mortgages off the books of lending institutions doesn't adversely affect the opportunities for mortgage modification—both to allow responsible homeowners facing mortgage-payment problems to avoid unnecessary foreclosures and to ensure that holders of mortgages choose modification over foreclosure where that will maximize the value of the mortgages they hold.
- Limits the holders of large quantities of toxic assets from participating in the PPIP investment vehicles that will purchase these assets.
- Applies appropriate standards for private fund managers chosen to purchase toxic assets from financial institutions.
- Makes transaction information readily available to ensure an efficient, fast-moving market.
- Sets up performance metrics to determine if the program is working as conceived.
- Provides the general public with information as the program proceeds.
- Includes the broad public in the benefits from any windfall profits.
- Ensures the amount of debt financing provided by taxpayers is not too high as Treasury fleshes out the amount of leverage it will provide as part of PPIP.

It is certainly a widely shared hope that PPIP will succeed for taxpayers, for financial markets, and for the economy. The reaction to the proposal has been mixed—with some optimistic and others deeply skeptical. The suggestions for implementation described here will make success more likely. But it is also true that if the PPIP approach doesn't work then even more intrusive government intervention will be required to address the severe challenges in our financial sector.

The Public-Private Partnership Plan in brief

PPIP in fact consists of two programs. The first one, which will buy whole loans off the books of banks, is called the Legacy Loans Program—which addresses toxic whole loans. The second one, which will buy securitized debt—mainly mortgage-backed securities—is called the Legacy Securities Program, which addresses toxic securitized debt. Although the two parts work in somewhat different ways, the key new element in both is a set of partnerships between government and private investors that buy suspect assets off the books of banks and other institutions. The government and private partners put up equal amounts of equity—although the administration suggests there might be some flexibility in this as the program proceeds—then the government provides additional funds through loans or guarantees of loans to the partnership.

Under the Legacy Loans Program, or LLP (not to be confused with "Limited Liability Partnership") banks will assemble pools of loans they wish to sell at auction. The Federal Deposit Insurance Corporation will examine these pools to determine how much leverage they would be willing to offer the buyers, up to a six-to-one debt-to-equity ratio, depending on the quality of the loans. The private buyers then will partner with Treasury to create Public-Private Investment Funds to buy the pools at an FDIC-run auction.

On a hypothetical pool of mortgages bought for $100, the Public-Private Investment Fund would put in $14 in equity and the FDIC would guarantee loans of $86 in exchange for a small fee and a second-loss position (meaning investors and Treasury would lose their equity before the FDIC would have to pay out any claims on the loans). Of the $14 in equity, half would come from the private sector and half would come from Treasury.

Under the Legacy Securities Program, or LSP, there is no auction process. Instead, private partners that want to participate in the program must be an approved fund manager to participate in a Public-Private Investment Fund for toxic securities. Treasury expects to qualify a relatively small number of fund managers initially, starting with about five. The proportion of debt versus equity is more complicated and needs some clarification, but it appears that the leverage could be considerably higher.

The two programs are structured so that if the investments make a profit, the government gets half and the private investor gets half—reflecting their equity shares. If the investment has modest losses, then the losses are also shared equally. If, however, the investments

experience extreme losses then the government (read: taxpayers) bears a greater share. This is because the debt portion of the investments is nonrecourse, meaning that the downside for the investors is limited to their equity investment.

Here's how it would work in the case of an LLP investment with a six-to-one debt-to-equity ratio. If the investment loses up to 14 percent of its value after the purchase of a set of whole loans from the banks then the loss is split evenly. Any losses beyond that are borne solely by the government. This imbalance has a number of potential ramifications for implementation of PPIP—ramifications that several of the recommendations we make below are meant in part to address.

Implementation to protect taxpayers, restore credit markets, aid responsible homeowners, and help the economy recover

There are a number of details still to be worked out in the implementation of PPIP within the broad parameters that have been released by the Treasury Department. As implementation proceeds, it is critical that steps being taken to repair our housing market are not damaged by PPIP. And both the LLP and LSP processes must be open to investor and public scrutiny, policed and measured to judge their efficacy, and structured to protect taxpayers as much as possible.

Impact on loan modifications and foreclosures

As the FDIC and Treasury establish rules for PPIP it is important to consider the interaction with existing efforts to ease the housing crisis. Of specific concern is that the administration's new mortgage modification program could be undercut by the PPIP's Legacy Loans Program. The administration's new Home Affordable Modification Program, or HAMP, requires participating loan servicers—including all future recipients of funding from the $700 billion Troubled Asset Relief Program approved by Congress late last year as well as major past recipients of TARP funding who are participating voluntarily—to work with at-risk homeowners to modify their loans in cases where modification preserves more value for the mortgages in the lenders' portfolio than proceeding to foreclosure.

Under the LLP, however, many of those loans are destined to be sold to investors who currently are under no such obligation to make mortgage modifications. To ensure that the purposes of the HAMP modification program are not thwarted, special care will have to be taken in the implementation of PPIP. This is critical because many of the loans eligible or likely to become eligible for modification under HAMP are among those most likely to be sold by banks under PPIP. Delinquent loans, which are the domain of HAMP, must be (by the strictures of accounting rules) written down on banks' books, which will inflict harm on bank balance sheets that the banks can ill afford.

HAMP offers banks incentives for modifying loans so that the loans are of greater quality after modification, but the shaky banks may well decide that they are better off selling the loans to completely move the risk from their books. Thus, special steps will be required to preserve the purposes of HAMP.

One approach would be to simply require the buyers of loans under the LLP to play by the rules of the HAMP modification program. This requirement would offer a consistent outcome for homeowners and mortgage holders. The new loan owners after an LLP purchase would be required to make the modifications under the same conditions as the banks and would also benefit from the incentives offered by HAMP—as would any successor owners. This ensures that the objective of HAMP is not thwarted and that taxpayers—as new partners in the ownership of the assets—aren't saddled with the losses incurred when loan servicers choose foreclosure in instances where modification offers a better return on investment.

Attaching too many strings on investors might keep them from participating in the Legacy Loan Program, but including HAMP requirements does not generally create a significant burden. Much of the analysis that will be needed to evaluate the parameters for loan modification under HAMP will probably be done as part of the LLP process—where the FDIC analyzes the risk of the loan to determine the amount of debt that it will guarantee as part of the transaction. In addition, the buyers of these loans are not likely to directly service these loans but rather hire a third party to do it, possibly even hiring the current owners to service them. As such, it does not present a significant burden for the buyers.

In addition, since modification under HAMP takes place only when the net present value of mortgage modification is greater than for foreclosing, it creates net value for the buyer rather than imposing a cost. In short, including HAMP requirements in the LLP would not be a burden and may well benefit private-sector participants as well as taxpayers.

Including HAMP requirements will help banks and the broader economy as well. From the beginning of the housing crisis, the Center for American Progress has consistently said that by helping homeowners at risk we can help banks, which in turn will help the economy recover. Now that we have a program in place that will finally offer sustainable modifications in keeping with a commitment to maximize returns to the note holders (investors and lenders), it would be a shame to put up public funds to transfer loans to third parties without this component.

What's more, including HAMP is likely a matter of established law. The Emergency Economic Stabilization Act of 2008, which established TARP, shows a clear congressional intent that Treasury acquires mortgages for the purpose of modifying them. To that end, Section 109 of the bill requires the Secretary of the Treasury, upon acquiring mortgages, to establish a modification program (such as HAMP) and to encourage servicers to modify mortgages. Because Treasury is buying an interest in mortgages through the LLP, this obligation should be present in the PPIP, or there should be some other effective measure to implement the congressional intent to modify mortgages and avoid unnecessary foreclosures.

Sellers shouldn't be significant buyers of toxic assets

Limitations should be placed on banks participating as buyers in PPIP if they are among the institutions this program is designed to rescue by removing toxic assets from their balance sheets. These banks would have a clear conflict of interest. As buyers they should demand prices be as low as possible, but as holders of substantial quantities of toxic assets and as sellers in the market their primary interest is to see these assets trading at as high of a price as possible. Were the banks to have a substantial presence in the market as buyers, they could inflate the prices paid and undermine confidence that the market is accurately setting the value of these assets. This could both discourage other prospective buyers and, in the end, undermine PPIP's objective of restoring faith that banks' balance sheets are appropriately valued.

For any buyer under PPIP there is a bias toward overpaying, a point expressed by a number of economists such as Paul Krugman, Martin Wolf, Jeffrey Sachs, Adam Posen, Nouriel Roubini, and Nassim Taleb. The reason: Buyers of these assets get half of the profits if the assets increase in value no matter how big the gain is, but their potential losses are limited to the amount of their equity investment. The dilution of risk for private investors will make them willing to pay a higher price. This PPIP feature creates the likelihood that there will be some overpayment for these assets. That doesn't mean most transactions won't turn a profit, or that taxpayers will be hurt—the buyers do have a profit incentive even if they are protected from extreme losses, and the difficulty in valuing the assets will engender caution.

For banks acting as buyers in the program, however, the motivation to overpay would be enhanced because of the impact of their purchases on the value of assets they hold and wish to retain and the assets they plan to sell. To the extent banks can drive up the market price for these toxic assets by overpaying, this will also affect the value on their books of similar assets that they currently own and retain. In addition, the assets they choose to sell would be sold at a higher price.

If banks came to dominate both the selling and buying, substantial overpricing is a possibility. Indeed, one characteristic of the Legacy Loan Program bidding process is that a bank can refuse to sell at the end of the auction. That is, if the bank doesn't like how the bidding turned out it can choose to hold onto its assets. That could create a market where financial institutions are the primary players on buying and selling—offering high prices for the assets and refusing to sell for low bids. The banks' motivation would be to make their balance sheets look better and take advantage of all of the government financing and equity investment and to shift the risks of deep losses to the taxpayers.

If banks were to become major players in the market, then it could undermine confidence in the price-setting mechanism of the auctions—a primary purpose of the public-private partnership structure. This could dampen interest in participating in the program by

others, reducing the total volume of purchases and further undermining the price-setting value of the auctions. This would substantially undermine the effectiveness of PPIP as it would fail to improve confidence in the value of the assets the banks are holding.

The PPIP premise is that, in order to get back on their feet, banks need to get these assets off their books. If the banks are buying up one another's assets that obviously isn't going to happen. And if they have dominated the market, there will be suspicion that the auctions have not resulted in appropriate re-pricing of the assets. That would leave us mostly back where we started—with banks holding large volumes of assets of questionable value.

In addition, the PPIP's higher purpose is to restore banks to a posture where they are lending again. This won't happen if the banks continue to tie up their resources in toxic assets. Although it may not be necessary to entirely exclude banks from participation as asset purchasers, their participation should be limited to a level that there is no question that their presence is having a substantial impact on the pricing of the assets. Further, banks should clearly not be allowed to purchase their own legacy assets directly or indirectly—a possible practice that has raised concerns by Nobel Prize-winning economist Jeffrey Sachs**.**

Standards for fund managers

To handle the purchasing of toxic securities—mostly mortgage-backed securities—the PPIP's Legacy Securities Program calls for the approval of "Qualified Fund Managers" with a "demonstrated track record of purchasing legacy assets." The Treasury has fleshed out this standard to a degree, but it should also consider additional criteria based on standards applied to government contractors.

The government considers a range of factors to evaluate an institution's "responsibility" record and "business ethics" when determining eligibility for a government contract. Companies that are deemed to have a poor overall record are not eligible. Factors that can be considered when evaluating a company's overall record include:

- Past performance on government-funded or government-subsidized projects.
- Record of compliance with laws, including labor and environmental laws.
- Tax payment history.

While some of these criteria are less applicable than others in the context of financial firms, financial institutions that have a track record of civic irresponsibility should be precluded. An overly puritanical standard might be self-defeating, but financial institutions that played substantial roles in putting the financial sector in its current condition should be precluded.

Setting such eligibility standards is important for three reasons: First, it is a way to ensure that funds are spent wisely. Companies that have poor responsibility records often short-change taxpayers, such as by failing to perform quality work or passing off hidden costs onto taxpayers, as a recent Center for American Progress Action Fund report under-scores. Second, high standards can help ensure that government programs don't promote irresponsible behavior or work at cross purposes. Without high standards, taxpayer funds will end up promoting poor corporate citizens, even as other government policies try to limit their abuses. Finally, addressing multiple public goals—including restoration of the housing sector through loan modifications—will require continuous engagement with responsible companies.

An open, transparent market in toxic assets

To make PPIP work at its best will require a fast-moving, highly-efficient market that restores confidence in the valuation of toxic assets. This won't happen if the private participants—the investors—are each acting independently without the benefit of an open, transparent market. Allowing market participants access to information regarding all of the transactions in the market will make for faster assessment of the subsequent transactions' value and create confidence in market participants that the prices they are getting—as either buyers or sellers—are within a range of consensus. This will make participation more inviting and enhance confidence that the assets are being priced appropriately—a critical step for restoring financial and credit markets to normal operation.

These assets, of course, are all unique to some extent. To use a very simple example, a $400,000 mortgage on a Southern California home worth $240,000 is a different beast than a $300,000 mortgage on a Boston condo worth $350,000. Nonetheless, investors must have open information about the pricing and characteristics of the assets being sold to ensure the new market will be fast-moving and efficient. The transactions for both programs should be made public. Information could include:

- The purchase price of a given asset.
- The portion of the price coming from the investor.
- The amount of government equity.
- The amount coming from loans and the source of the loan and the nature of any government guarantees of the loan.

In addition, specific characteristics of the asset should be disclosed to the greatest extent available. Information disclosed could include, in the case of a whole loan, the location and nature of the property secured by the loan and second-lien information. In the case of a security, then the credit rating of the security, the nature of the underlying assets, default

rates, the originator of the security, and other pertinent information that is an indicator of its likely risk and value should be disclosed. The name and identifying information for the buying and selling parties, and book value—the value of the asset on the selling party's balance sheet—should also be available.

Metrics for success

The PPIP program and the "stress tests" now being conducted on the nation's largest financial institutions by financial regulators are keys to cleaning up our banks' balance sheets, restoring their health, and returning normalcy to credit markets. There are, however, questions as to whether PPIP will succeed in its goal of restoring a degree of trust in the value of assets and balance sheets of financial institutions.

The overriding question on whether the program is succeeding will be whether the private buyers and sellers of the legacy assets will be able to come to agreement on prices for the assets and conduct a sufficient volume of transactions for the program to achieve its goal. The other question is whether taxpayers are getting a fair deal.

The administration should set up, in advance, clear measures for what a successful PPIP would look like. It is important that clear goalposts be established with objectives to be achieved within specified spans of time. Targets could include the portion of bank balances that are comprised of legacy assets, or the number of banks that have gotten that proportion below a specified level. There could also be targets set for the amount of risk that is being assumed by taxpayers.

In some cases, existing aspects of the program already provide a basis for measuring progress toward targets. The FDIC, for example, will be doing risk assessments for the Legacy Loan Program—assessments that will affect the amount of debt level it will guarantee. These assessments could form the basis for measuring total taxpayer risk. The Legacy Securities Program has no parallel mechanism, but the Treasury should carefully monitor the securities that are being purchased and the risk level it is incurring on behalf of the taxpayer by monitoring the performance of the securities. Income flows could be one metric as could total leveraging as a measure of the broader exposure of taxpayers.

Progress toward the established objectives—using quantified measures of restoring the health of financial institutions at the least risk to taxpayers so that banks can resume normal lending operations—should be reported frequently. Should progress towards these objectives fall short, or should the exposure of the taxpayers become too great, then the administration should take action to adjust the program.

PPIP may succeed gloriously. But these are difficult and uncharted waters and if it isn't working; problems should not be swept under the rug. The U.S. economy cannot afford

another failed, expensive attempt at restoring our credit markets to stumble along with little to show for it. Setting up performance metrics beforehand will serve to discipline the program and ensure that isn't allowed to happen.

People's piece of the action

PPIP offers a substantial subsidy for the private investors that participate—both from the protection from extreme losses and the presumably low interest rates on the loans to the partnerships. It very much remains to be seen how richly well-heeled private investors and institutional investors will be rewarded by their participation in Private-Public Investment Funds that will buy toxic loans and securities—but the possibility of enormous profits exists. If that happens, and the government doesn't have to cover too many large losses—then there could also be a windfall to government coffers as an equal equity investor.

The government's share of the profits would obviously benefit all Americans as the public debt would be reduced or government programs expanded. But that's a rather diffuse and abstract benefit relative to what the deep-pocketed direct investors, pension funds, insurance companies, and other institutional investors would be getting. We could see a pattern that many Americans are a bit tired of—some of the well-heeled financiers that created the financial crisis scoring big from programs subsidized by taxpayers. What's more, any benefit that comes to taxpayers as the ultimate beneficiaries of the government's profits also benefits private investors—they're taxpayers too. So if the investments turn out to have high payoffs the private investors win twice: first as investors and second as taxpayers.

This suggests the tapping of the government profits for a direct benefit to the taxpayer. The most obvious approach would be to offer a tax rebate to middle- and low-income families paid for by any government profits. The most prudent course would be to make this payable only if the profits are extraordinary—after they exceed an initial amount that would be set aside to helping to restore the nation's owned tattered balance sheet. Thus, if the profits do end up being extraordinary, middle- and low-income Americans would receive a direct return just as they will have to, eventually, pay for any loss should the investments in assets go extremely bad.

An argument can certainly be made for putting any government's windfall profits to deficit reduction or important national investments. In general, given the nation's needs, those should be higher priorities. But under the circumstances, perhaps ordinary Americans should, in the scenario where profits end up being substantial, get some very immediate and direct benefit this time.

Making information public

In accordance with the time-honored principle that "sunshine is the best disinfectant," the PPIP should be structured with a high degree of transparency. In addition to the information described above that is needed for the functioning of an efficient market and for measuring progress using established metrics, the administration should ensure transparency in the following areas:

- Choosing qualified fund managers for the Legacy Securities Program. Because this program is expected to work by providing subsidies to investors, these asset managers are being awarded a privileged position. As such, the Treasury should be completely transparent about the criteria and process by which these fund managers are chosen.
- Private equity. The private investors will be required to put in a small portion of the overall purchase price as equity. The specific amount of equity is expected to vary between different classes of assets. Because this financing is non-recourse, the amount of equity contributed is crucial since this is the only buffer the government has against losing money should the value of the asset ultimately be less than the purchase price. Treasury should publish for public consumption a schedule of the equity requirements for different types of assets.
- The amount of subsidization being offered. Both major initiatives of the PPIP provide debt financing to private investors at low interest rates and with protection against very large losses. The value of subsidies should be reported. If sellers in the PPIP program are allowed to be buyers as well, then there should be public reports of the extent of their participation on both sides of the market
- Performance. Statistics should be made available on the performance of the securities and loans in the program, including the percentage of which boast "negative equity" (the debt portion is worth more than the secured assets), the status of underlying loans, and the numbers of modifications.

Appropriate leverage ratios

The Legacy Securities Program features Public-Private Investment Funds with loans from the Treasury as high as matching equity investments by the government and private investors. On its face, this means private equity would be at least 25 percent of the pool. But there's a catch.

The Public-Private Investment Fund is eligible for so called Term Asset-backed Securities Loan Facility, or TALF, financing to purchase troubled assets. Originally, TALF was designed to encourage institutional investors to purchase newly issued investment-grade,

asset-backed securities, but the Treasury is now expanding TALF as part of the PPIP plan. It's not clear how this is going to work, but given the TALF's current 6-to-1 debt-to-equity ratio, it could mean that a private investor utilizing the LSP and TALF to purchase toxic securities would contribute only 1/28th of the total investment amount, while receiving half of any profits.

Because the details of TALF's expansion to include toxic securities are still to come, it is not clear how this new program will work in practice, but it is fairly clear that TALF will significantly extend the leverage enjoyed by private investors. Increased leveraging —more government lending to the LSP partnerships—creates much greater risk of losses being absorbed by the taxpayer. Treasury, in crafting the final details of PPIP and the revised TALF, should carefully ensure that this leverage is not too excessive.

Conclusion

Whether PPIP succeeds is of great importance to the nation, and implementing it well is critical. The suggestions above would make it operate more efficiently, better protect taxpayers, provide alerts if the program is failing or going astray, and provide the public with information on the program's effectiveness and integrity. These are principles that should underpin PPIP as it plays its vital role in restoring the economy.

About the authors

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