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Title: Where rocky horror assets go

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With injections of government capital seemingly having little effect on restoring confidence in ailing banks, thoughts have once again turned to quarantining distressed assets. Rob Davies examines the options available to policy-makers

In the recent history of financial crises - from the collapse of savings and loans institutions in the US in the late 1980s to the Asian financial crisis of 1997/98 - initiatives to separate good assets from bad have been at the heart of resolution efforts. In this, the latest turbulent episode of the financial sector, several major banks across the globe have teetered on the brink of collapse as losses, initially confined to structured credit exposures, have spread to conventional loan portfolios. Consequently, governments are once more looking at how to remove toxic assets from the system, a process they now see as critical in freeing banks to extend credit to pre-crisis levels.

In a note prepared for a meeting of G-20 finance ministers and central bankers in London on January 31, the International Monetary Fund (IMF) stated: "Cleaning bank balance sheets - including through a transparent process for valuing distressed assets and putting a ceiling on losses - will be critical to restore confidence in financial institutions and reduce counterparty risk. An approach that would ensure maximum transparency and greatly reduce uncertainty, although entailing high upfront fiscal costs, would be to transfer the assets to a bad bank. Such an approach has been tried and tested in previous crises and has yielded generally favourable outcomes."

The use of 'bad banks', whereby governments buy the assets outright and manage them through a separate vehicle, has gained traction since the start of the year, as has the alternative of 'asset protection schemes', which would see the assets remain on bank balance sheets but benefit from government insurance against future losses. A key part of the latest US rescue plan announced in February - the public-private fund - hopes to use both government and private funds to purchase assets.

However, all these routes face substantial challenges: in addition to widespread public opposition, selecting and then valuing the assets to be bought or protected at a level that is acceptable to the government (and its electorate), as well as the selling institution, is extremely complex.

Clouding the valuation further still, the lack of certainty about when the economic downturn will bottom out makes the timing of any government purchase a lottery.

Nevertheless, piecemeal efforts to resolve the present crisis - an injection of central bank funds into the interbank lending markets here, an infusion of capital into troubled institutions there - have proved inadequate. "The overall risks for the economic system at large are so great, governments fear that allowing systemically important institutions to fail is something that could kill the overall economy," says Norbert Walter, Frankfurt-based chief economist of Deutsche Bank. "So they are willing to go very far to find a solution."

And on announcing the latest US rescue package on February 10 - the Financial Stability Plan - Treasury secretary Timothy Geithner said decisive and urgent action was needed. "The force of government

support was not comprehensive or quick enough to withstand the deepening pressure brought about by the weakening economy," he said, adding that the Great Depression in the 1930s and Japan's decade of stagnation in the 1990s were exacerbated by inadequate policy responses.

In fact, proposals to quarantine impaired assets have already been mooted during the current crisis. Back in October 2007, Bank of America, Citi and JP Morgan came up with a plan to buy highly rated assets from structured investment vehicles (SIVs). These vehicles funded themselves through short-term commercial paper (CP) markets to invest in high-yielding, longer-dated securitised products, including collateralised debt obligations of residential mortgage-backed securities. With credit conditions deteriorating as a result of the escalating subprime mortgage crisis, the SIVs - many featuring liquidity facilities provided by banks - struggled to raise short-term financing in the CP market, leaving them unable to meet liabilities.

To avert losses stemming from a fire sale on the open market, the banks wanted to move the assets into a so-called master liquidity enhancement conduit, in the expectation that, as conditions improved, they would be more likely to realise their par value. In December 2007, the scheme was abandoned, in part because those involved could not agree on the true value of the assets.

Fast forward to October 2008, and the US government unleashed the Troubled Assets Relief Program (Tarp), created to purchase or insure up to $700 billion of impaired assets. However, with market volatility heightened in the wake of the collapse of Lehman Brothers last September, the valuation obstacle proved insurmountable. Ultimately, the government used $350 billion of the Tarp to recapitalise banks, while its peers across Europe adopted similar measures.

While government injections provided temporary relief, they did nothing to address toxic assets or encourage banks to increase loan origination. And if anything, the asset problem is getting worse. In January, the IMF raised its estimate of potential financial sector writedowns on US-originated assets to $2.2 trillion from $1.4 trillion, noting much of the recent deterioration in the value of assets occurred in corporate and commercial real estate securities and bank loan losses.

In the structured finance space, rating agency Moody's Investors Service on February 4 reported that weakening US economic conditions are putting severe pressure on commercial mortgage-backed securities (CMBSs). Consequently, the agency is assuming double the expected loss on collateral backing $302.6 billion of CMBSs. Although super-senior and mezzanine Aaa-rated tranches representing 72% of the total should not be affected, Moody's warns investment-grade bonds going up to junior Aaa tranches could be downgraded by four or five notches on average. Meanwhile, lower-rated investment-grade and speculative-grade bonds could be downgraded by five to six notches.

Pressure

For banks holding lower-rated tranches, the downgrades could put even more pressure on capital. And experts say the threat stretches way beyond CMBSs. "In the non-agency mortgage market, about $1.5 trillion of super-senior paper has a high risk of being downgraded below investment grade," says Tonko Gast, co-founder and chief investment officer at Dynamic Credit, a New York-based structured finance investment firm. "Currently, banks can hold as little as 1% against those assets, but if they get downgraded, they may need to set aside 50% or even dollar-for-dollar against those assets. The amount of capital needed is a multiple of the economic loss in a stressed scenario."

Some banks - for example, Citi in the US and Royal Bank of Scotland (RBS) in the UK - have sizeable mortgage and consumer loan books, as well as structured credit exposures. And these conventional loan markets are also under severe stress.

According to RealtyTrac, a Californian real estate company, the number of foreclosures in the US increased by 81% in 2008 to 3.2 million. In the UK, meanwhile, The Council of Mortgage Lenders, an

industry group, reported that 40,000 homes were repossessed last year, up from 25,900 in 2007 - and it expects the figure to exceed 75,000 this year.

Banks have tightened lending conditions as a result of the gloomy economic outlook. In the latest US Federal Reserve senior loan officer survey, released in January, 65% of domestic banks reported a tightening of lending standards on commercial and industrial loans, while 70% increased spreads on loans and introduced tighter covenants.

The picture is similar across Europe. In the European Central Bank's January bank lending survey, 64% of banks reported a tightening of credit standards for corporate loans, not only as a result of economic concerns but also because of their own balance-sheet constraints and limited access to market financing.

Bloomberg estimates banks globally have raised $826 billion during the financial crisis - $380 billion through government support - to cover writedowns totalling $792 billion. And, in the absence of further state intervention, the IMF estimates they face a net capital shortfall of at least $500 billion during 2009 and 2010, reinforcing the idea that addressing problem assets is critical.

Given the gravity of the situation, it is tempting to draw parallels to past crises, when bad banks were used to varying degrees of success. The Resolution Trust Corporation, for example, was created in 1989 to sell off assets from defunct savings and loans institutions in the US, a process that ultimately came at a cost of $153 billion to the government. When Swedish banks faced ruin in 1990 from the bursting of a housing and asset price bubble, two firms - Nordbanken and Gota Bank - became insolvent and were temporarily nationalised.

The Swedish government established two asset management companies (AMCs) to deal with Nordbanken and Gota's problem assets. Critically, by removing assets from their balance sheets, the two banks could function normally. And, under no time constraints, the AMCs were able to conduct an orderly sell-off of assets over a seven-year period.

However, those crises were different from the current calamity. In the US, the savings and loan firms were already defunct - the Resolution Trust Corporation was a sensible means to conduct an orderly sell-off of their assets. Contrast that to today, when the government is trying to address the asset problem in such a way that doesn't cause banks to go under.

The Swedish problem was localised - the economy was already showing signs of bottoming out and its exporters were able to benefit from massive currency depreciation. "Those problems were contained within a ball park that could be understood," notes Deutsche's Walter. "Today, we are looking at numbers that are mind-bogglingly high and confronted with something that cuts across a far wider spectrum than anything we've seen over the past 60 years."

Nevertheless, while the severity of this crisis may exceed previous cases, there are those that insist bad banks can play an important part in the resolution effort. "Some of the characteristics of the bad bank solution - specifically, the clear-cut nature of removing assets from banks - remain strong arguments in favour of this method," says Jan Brockmeijer, deputy director of the monetary and capital markets department at the IMF.

While acknowledging the valuation issue has proved elusive to the establishment of bad bank-type vehicles during this crisis, Brockmeijer insists putting a value on both the size of troubled asset portfolios and further losses that might be suffered on them is essential to removing uncertainty and restoring confidence, even if that means more pain for banks.

"The process may result in banks having to take further writedowns. But this is part of the resolution effort - at least there will be more clarity on how big the hole is and the measures required to deal with it. Some institutions might be able to resolve problems by using their own buffers or attract private-sector capital.

And for institutions unable to do that, governments will have to decide what level of public-sector capital is needed and against what conditions," adds Brockmeijer.

There are various schools of thought on how a bad bank could work in the context of this crisis: some advocate the use of a single aggregator institution, while others prefer the use of special-purpose vehicles (SPVs) to deal with individual banks' problems. Either way, the valuation riddle still needs to be solved. And while challenging and time-consuming, it is not impossible so long as the asset being assessed has some intrinsic value.

When De Nederlandsche Bank, the central bank of the Netherlands, was negotiating a deal (completed in January) to reduce the risk on ING's $39 billion portfolio of US Alt-A mortgage-backed securities, it hired Dynamic Credit to come up with reasonable loss scenarios in a base case (factoring in a nationwide decline of 35% in house prices) and stressed case (a 65% drop). "The portfolio was linked to an underlying pool of 600,000 mortgages. We drilled the process down for each loan, looking at the current loan-to-value (LTV) to assess both the ability to pay and willingness to pay. If, for example, someone has a current LTV of 125%, the willingness to pay looks at risk. This process enabled us to come up with losses at the loan level, pool level and the bond level," explains Dynamic Credit's Gast.

Instead of a direct asset purchase, the transaction between the Dutch government and ING was structured as an 80:20 cashflow swap, with the government receiving 80% of cashflows on the assets while assuming responsibility for the same level of any losses. As well as potentially getting 20% of any upside, ING said the deal lowered its risk-weighted assets by EUR15 billion and helped raise its tier-one capital ratio by 40 basis points to 9.5%.

Adrian Blundell-Wignall, Paris-based deputy director of fiscal and financial affairs at the Organisation for Economic Cooperation and Development, supports assets being bought on to the public balance sheet in the short term, if only to reignite the interest of private investors. He believes the starting point for valuation has to be a detailed assessment of what the ultimate hold-to-maturity losses will be on each asset, to give an idea of average pricing.

"Governments could then start a reverse auction for the assets it wants to buy - aggressive buying by a government agency could spur other investors to come back to the market. And if that process fails, at least the government can hold the assets until maturity and the repayments have been made, because it does not have to mark-to-market. If the assets are bought for 50 cents on the dollar on average, but in 15 years' time they realise 70 cents, the taxpayer makes a profit," says Blundell-Wignall.

Apart from forced sales, one reason why banks have been unable to shift large portfolios of credit assets off their books has been a significant discrepancy between their own valuations and those of potential buyers. For less complex assets, such as prime residential mortgage-backed securities, credit analysts report bid/offer spreads of between 5bp and 10bp, but when moving into less-liquid products, the differential has been as high as 70bp in some cases.

The US government's public-private fund, a key feature of the US Financial Stability Plan announced in February, may be seen as a means to bridge the gap. The government wants to use a combination of private capital and up to $1 trillion of public finance to restart the market for the real estate assets at the heart of the crisis. Details on how the scheme could work are vague at this point, but investors think it could be workable as long as government guarantees are attached.

"There will have to be some form of guarantee to kick-start the programme, but once there is some clarity on asset value, you will start to see a lot of participation," believes Tom Sowanick, chief investment officer of New Jersey-based asset manager Clearbrook Financial. "It all comes down to the initial purchase - what level do I buy at. But we would want protection against losses going beyond a certain level - maybe they could guarantee anything up to a 25% loss to get the process rolling."

Others are not so convinced. "A two-party transaction between government and bank is complicated enough to negotiate and do the necessary position-by-position analysis," says Paul Noring, managing director, financial services, at Washington, DC-based risk consultancy Navigant Consulting. "When you move into a public-private scheme, it is going to make the logistics extremely complicated. The discount needed to clear the hurdle rate of private investors will be significantly higher than the government's. I think it will be much more difficult to move forward with this model than it would be for the government to acquire assets directly and, over time, try to sell them to the private sector."

Banks clearly do not want to sell assets at levels below which they are currently marking them on their books. But if there is no other option but to sell to relieve pressure on their balance sheet, an alternative would be for governments to set up individual vehicles, principally funded by public money but in which the banks also hold an equity stake. If, as the banks claim, the market values are significantly below the assets' intrinsic value, it can benefit from any upside as they mature.

This, essentially, is the arrangement UBS entered into with the Swiss National Bank (SNB), which established a $39 billion vehicle - the Stabfund - to purchase a mixed portfolio of US and European asset-backed securities and super-senior collateralised debt obligation tranches. As long as assets increase in value between now and their maturity date, the central bank makes a profit, as does UBS, which will acquire a 10% equity stake in the vehicle. But if the Stabfund ultimately incurs a loss, SNB is entitled to 100 million ordinary shares in UBS.

The kind of protection demanded by SNB may be enough to mitigate concerns it overpaid UBS, the purchase price being only $300 million lower than where UBS marked the assets at the end of September 2008. And some observers insist government agencies can ill afford to penalise the banks too severely.

"One key driver to get the toxic assets off their balance sheet has to be a decent clearing price," says Vivek Tawadey, London-based head of credit research and portfolio strategy at BNP Paribas. "If the assets are priced too high, it creates a loss for the government and the taxpayer; if it is too low it further erodes bank capital. This gap needs to be bridged - and the injection of preference capital by UBS into the SPV partly addresses this problem. As the assets are held to maturity or sold, any gains should be shared by the selling bank and the government."

However, the upfront costs associated with the bad bank solution have led many governments to seek alternatives. Already in the US, the government has entered into asset protection schemes with Citi and Bank of America, a process that involves a specific asset pool ring-fenced from the rest of the bank - while still remaining on the balance sheet - but benefiting from government insurance. Citi's deal, for example, sees the bank liable for the first $29 billion of losses on a $306 billion securities portfolio and 10% beyond that, with the government shouldering the remaining 90%.

The UK government has also shown a preference for asset protection. On February 26, it anounced a scheme to ring-fence a £325 billion pool of assets held by RBS, in which it has a 70% stake. The bank will be responsible for a first-loss portion, plus 10% of losses beyond that, with the government taking the remaining risk. It will charge a 2% fee for insuring the assets, with RBS also forgoing its entitlement to deferred tax assets. The deal will reduce RBS' risk-weighted assets by £144 billion.

Governments and regulators have claimed excessive leverage in the credit derivatives market played a major part in distorting the financial system. So there is some irony in the fact that asset protection works very much like a credit default swap (CDS), allowing governments to get a tremendous amount of leverage over a vast pool of assets with no upfront cost.

Roberto Henriques, a London-based credit research analyst at JP Morgan, acknowledges the point but believes this method has benefits for all parties. "In a CDS contract, you are effectively able to substitute the risk weighting for the asset with that of the protection seller. This is one of the advantages of the asset

protection scheme - because the protection seller in this case is the government, it will enable banks to achieve a significant reduction in risk-weighted assets."

Other advocates of asset protection believe the scheme also removes the tricky valuation issue. "Guarantees are less dependent on a precise agreement on the current value of the toxic assets, since the banks would take a substantial hit before the guarantees kick in," says Douglas Elliot, fellow, economic studies, at the Washington, DC-based Brookings Institute. "Leaving the assets under the management of the banks, covered by a guarantee, better aligns the economic incentives to maximise the value of the assets than does moving them to a bad bank."

However, having asset protection has so far done little to appease investor concerns about Citi or Bank of America. Citi's five-year CDS levels increased 108% between December 31 and February 19, from 189.1bp to 393.6bp, while the cost of protection on Bank of America increased 101.9%, from 117.3bp to 236.8bp, over the same period.

"Given the sharp rise in foreclosures, there is concern that assets outside the scheme are at risk of becoming impaired," says Bijal Shah, London-based global chief economist at Societe Generale. "That is why the most troubled banks have experienced a further hit to share prices, because there is still concern about whether their current capital levels can withstand further loan losses on the mortgage book and corporate loan book."

Neither the bad bank solution or asset protection schemes are perfect, but may go some way to stemming the losses that have hindered financial institutions over the past two years. But governments may have to go even beyond these measures if they want banks to extend credit at pre-crisis levels.

"At this point, banks have little incentive to lend because of the current state of the economy. The only way for governments to control lending is nationalising the banks," warns Olivia Frieser, a bank credit analyst at BNP Paribas in London.

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