

IN SEARCH OF A PLAN TO MAKE TOXIC ASSETS DISAPPEAR

Toxic assets related to mortgage lending are a top priority for both policymakers and financial institutions that are struggling under the weight of bad debt. Underperforming assets sitting on damaged balance sheets of financial institutions were the main cause of the credit crunch that launched the current recession, and governments of major economies are looking for ways to make those assets go away.

Ranging from government buyouts to insurance programs that would cover losses for lenders, these efforts raise as many questions as hopes. One thing is readily agreed upon by all, however: answers are needed.

Intense and unprecedented public intervention following the credit collapse last fall helped stop the downward spiral. More than two dozen initiatives under the auspices of the Federal Reserve, the Treasury and the FDIC are valued at many trillions of dollars. This includes the funds for the AIG credit extensions, the Fannie Mae and Freddie Mac bailouts, as well as other stimulus packages. Some of these programs – the Treasury Asset Relief Program (TARP), the Capital Assistance Program (CAP) and Public-Private Investment Programs (PPIP) – have begun to address the toxic asset problem, but only in part. While these programs have set aside money, leaders are just now figuring out how best to spend it. Every option is being considered.



PUBLIC-PRIVATE PARTNERSHIP

In late March, the Treasury and Federal Reserve announced that under the new Public-Private Investment Program, \$100 billion in TARP funds will be used to entice private capital to help purchase troubled assets. The investments will be backed by the FDIC, offering potential participants a greater level of security. The FDIC's primary stipulation is that there must be a 6-to-1 debt-to-equity ratio for bank assets to be part of the program. While news of this solution has been viewed positively by Wall Street, several other approaches may yet come into play.

BRITAIN'S INSURANCE-BASED APPROACH

Under Britain's newly initiated Asset Protection Scheme, the British government will insure over £500 billion pounds of toxic assets owned by banks in an attempt to avoid nationalization of the U.K.'s top financial institutions. Banks will take the first loss (10%) on underperforming or nonperforming assets, with the remaining 90% covered by the insurance plan. Several major banks have already joined in the scheme.

THE BAD BANK

Switzerland has created a so-called "bad bank," an entity whose function is to purchase toxic assets at a reduced price and thereby isolate them in one location. While this might offer a quick fix in getting these troubled assets off the banks' balance sheets and might help stabilize the banking system, an enormous burden falls to the taxpayers. In the U.S., we have seen a political backlash associated with such large-scale bailouts. In addition, most FIs are not eager to unload their bad assets at mark-to-market prices, as required under the bad bank plan. Such an arrangement could significantly decrease their asset base, simultaneously angering shareholders and increasing the risk of collapse. Another concern for the banks is that by selling these assets at dramatically reduced prices, either voluntarily or under government pressure, they will be denied any chance to recoup their losses when the real estate market and the overall economy improves. There has been some movement on the application of mark-to-market accounting in the bad bank approach, but not enough to have a substantive impact so far.

MASSIVE CAPITAL INFUSIONS

Another proposed solution is further massive federal infusions of capital. Proponents argue that such government actions would encourage banks to take a loss on their toxic assets and move them off the balance sheet that way. The capital infusion under TARP has helped, but its long-term effect is hard to gauge. This solution, like other federal bailouts, is being met with growing political resistance, as public outcry escalates over lack of regulation, foresight and effectiveness.

PRIVATE SOLUTIONS

Given the political reality, there is more incentive than ever to find private solutions. The Treasury Department's newest program reflects this trend in joining public funds with private capital; beyond this, lenders are finding their own recourse. Some have already put into place rent-to-own options, in which a defaulted mortgage is handled as a rental property instead of sitting empty. While there are inevitable logistical problems associated with these arrangements, such as responsibility for repairs and various other landlord-related issues, the hope remains that they will provide enough of a return to allow the lending institutions to tread water until the housing market stabilizes. According to a recent article in *American Banker* ("Lenders Play Landlord via Rent-to-Own," March 9, 2009) Freddie and Fannie are both considering a rent-to-own option for borrowers who are facing foreclosure and for the rising number of homes that are sitting empty without drawing any form of revenue.

Whether public or private solutions – or a mix of the two – prevail, increasing concern over the stability of global markets and the role that toxic assets play in endangering that stability has created a need for action. Addressing the impact of toxic assets on balance sheets will not only be an immediate priority in the upcoming months, it will be a primary factor in determining how quickly the world economy recovers.

CONTACT

John Bayeux
Financial Institutions Practice Leader
212 915 7945
john.bayeux@willis.com