Geithner plan helps cleanse bank balance sheets but is no cure-all

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- Treasury Secretary Tim Geithner unveiled long-awaited details of his Financial Stability Plan to the acclaim of a number of major institutional investors as well as of the stock market.
- The core of the scheme is a Public-Private Partnership Investment Program, PPIP, through which the US Treasury will co-invest with private sources of funds to buy so-called “legacy loans and securities” from banks.
- Treasury essentially has pasted together two entirely different schemes, with differing mechanics and sources of financing: (1.) A legacy loan program to auction off troubled loans, overseen and financed by the Federal Deposit Insurance Corporation, FDIC; and (2.) a legacy security acquisition program that will be partially financed through the just-launched Fed-Treasury Term Asset-backed Securities Loan Facility, TALF.
- Notwithstanding the strong vote of confidence of the stock market and big investors, the ultimate success of the initiative is not assured. It depends on whether banks are ready and willing to sell illiquid assets at prices below where they are currently marked on bank balance sheets.

Treasury’s two-prong plan to shift assets from banks to investors

In the month since Treasury Secretary Geithner sketched the outlines of his Financial Stability Plan but failed to provide any details of how the contemplated Private-Public Investment Partnerships would work, the US stock market plunged by more than 20% and numerous members of Congress from both political parties were calling for his resignation. But by the time the details of his plan were unveiled this past Monday, the mood was already starting to change, most tangibly in the equity market, where bank stock prices had begun to revive. Geithner’s announcements silenced many of the critics and touched off a spectacular rally on Wall Street. Supporters bought into the Treasury’s argument that finally something would be done to rekindle an active secondary market in formerly illiquid securities and also offer banks the opportunity to shed loans from their balance sheets that had not been securitized and were therefore unmarketable.

What made the difference is relatively straightforward: The Treasury had found a way to magnify the dwindling resources (now just USD 100 bn or so) of the existing Troubled Assets Recovery Program, TARP, by coming up with two separate facilities for letting banks sell off legacy assets they now hold, including troubled loans as well as illiquid, toxic securities. It did this in two ways: By mobilizing the considerable financial resources and professional expertise of the FDIC through a legacy loan program. And by sponsoring private-public investment funds that would be able to bid for toxic securities at prices closer to those at which potential sellers would be willing to do transactions.

In each case, the Treasury will be a 50-50 co-investor in the equity of the funds, using the rest of the TARP money. That will provide upside potential for the taxpayer, although admittedly the taxpayer will actually be taking the bulk of the risk, since funding provided by the FDIC and by the Fed, through the TALF, is also public money. In addition, the terms and conditions of the two arrangements are generally attractive to potential private sector investors. Many respected fixed-income investment specialists, not least PIMCO and BlackRock, immediately endorsed the program and expressed interest in taking part. What is more, the impressive stock market rally triggered by the Treasury’s announcement indicated that many investors are confident that the program will work.

The main question is whether the banks now holding legacy assets will be prepared to take part. Our view is that the legacy loan program is likely to attract interest from banks throughout the country, regionals and

super-regionals, not just the biggest Wall Street institutions. In contrast to the US Treasury's description of the program, banks may not merely try to unload "troubled" or "distressed" mortgage loans but will also be willing to submit pools of performing mortgage loans that are ineligible for Fannie and Freddie guarantee programs and other illiquid, but valuable assets. The reason is that the securitization of loans in general has become extremely difficult since the financial meltdown worsened last summer, particularly for small and medium-sized institutions. Access to equity capital is also limited. Thus, selling loans to investors by utilizing the Treasury's scheme will probably turn out to provide the cheapest source of additional equity capital. More problematic will be the legacy securities program. The reason is that unlike the auction-based mechanism of the legacy loan program, the legacy securities version is unlikely to resolve the fundamental problem of asset valuation. It has been the inability of potential buyers and sellers to come to a common view of valuations that has already stifled private sector attempts to reactivate a moribund secondary market in mortgage-backed securities, MBS, and collateralized debt obligations, CDO, based on them.

Legacy loan program: a Treasury-FDIC joint venture with private investors

The legacy loan program is not uncomplicated and more work needs to be done fleshing out the specific requirements. But its principle components are reasonably comprehensible. It is a joint undertaking of the US Treasury and the FDIC. Pools of loans offered by individual banks will be sold at auction. Buyers will be pre-qualified private investors who will establish PPIP investment funds to hold the pools after they make a successful bid. These investment funds will have an equity base that includes the US Treasury as a co-investor. They will gain access to financing through guarantees provided by the FDIC, for which they will pay a fee. The FDIC will set requirements, subject to Treasury approval, as to which bank loans or other assets are eligible for the program. Banks of all sizes and all parts of the US that have loans on the balance sheets that they would like to encash will submit proposals. Because the participant banks must demonstrate the submitted loan pools meet the requirements, the FDIC will do due diligence to assure that they are met and that FDIC guarantees up to 6:1 leverage can be provided.

The FDIC will also play the main administrative role in the formation and funding of the PPIPs and in conducting the auctions (and there may be dozens, even hundreds of them, if the program truly takes off). PPIP investors can be almost anybody. Here is the Treasury's list: "financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds, pension funds, foreign investors with a headquarters in the United States, private equity funds, and hedge funds." The Treasury presumably feels that enough private investors will take part to ensure reliable auction results, especially in terms of price discovery. But the banks submitting the pools to the auctions have the right to refuse all bids if they judge the prices to be too low.

In sum, most banks that want to encash a portion of their loan book are likely to find the Treasury scheme more immediately useful than the moribund asset-backed securities market and probably cheaper as well. They don't have to pay a hefty fee to an investment banker, for one thing. As for the potential investors, they are under no obligation to bid in any particular auction but they are empowered to bid more aggressively in the ones they enter because they are assured of financing on probably generous terms (some spread over the cost of funds to a government agency, because FDIC is providing a guarantee).

LEGACY LOAN PROGRAM: TREASURY'S EXAMPLE

Step 1: If a bank has a pool of residential mortgages with $100 face value that it is seeking to divest, the bank would approach the FDIC.
Step 2: The FDIC would determine, after due diligence, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio.
Step 3: The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector – for purposes of the Treasury's illustrative example, $84 – would be the winner and would form a Public-Private Investment Fund to purchase the pool of mortgages.
Step 4: Of this $84 purchase price, the FDIC would provide guarantees for $72 of financing, leaving $12 of equity.
Step 5: The Treasury would then provide 50% of the equity funding required on a side-by-side basis with the investor. In this example, Treasury would invest approximately $6, with the private investor contributing $6.
Step 6: The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC.

Source: US Treasury Fact Sheet of March 23, 2009

A little history: selling pooled loans

Some critics of the Geithner plan have taken at face value the Treasury's statements that the legacy loans that will be pooled and sold to PPIP investors will be entirely bad or "toxic." We doubt that will be the case. The Treasury also emphasizes that the FDIC will be scrutinizing the loan pools a participating bank intends to sell to assure themselves that they are of a quality high enough to justify the FDIC's providing guarantees of up to 6:1 leverage. Experience shows that the FDIC will not take this due diligence responsibility lightly. Instead, we suspect that the selling banks will offer a considerable number of performing loans, those that are current on both interest and amortization, in order to pass muster with the FDIC.

Why would they want to sell performing loans? Isn't the whole point of the exercise to rid them of non-performing loans contaminating their balance sheets? Not exactly. The realized losses that a selling bank would have to take could be extremely nasty and would almost certainly force them to find new capital, either in the private market or more likely from the US government, to be able to absorb those losses.

The history of the pooling of bank loans points to a different conclusion. The time was the late 1980s. Citibank, then as now, was faced with significant difficulties and heavy expected losses. Their commercial real estate lending business was in trouble, and the financing of leveraged buy-outs was turning sour. Access to private capital was becoming more restricted. The crown jewel of the Citibank brand was its world-class credit card business. It was growing rapidly at home and internationally. Many other banks and credit card specialists drooled at the prospect of being able to buy the business intact. Many top Citi executives were convinced that such a sale would be viewed in the marketplace as an act of desperation, evidence that the bank's problems were far worse than people previously thought.

But there was a way out: continue to run the business but sell the credit card receivables. That would turn out to be the cheapest way to raise capital, far cheaper than through new equity issues or rights issues. The problem was implementation. Mortgage securitization had been around for almost a decade and as the business matured, it was completely embraced by even the most skeptical fixed-income portfolio managers. Some fledging attempts to extend the concept to other asset classes were made but figuring out how to do this asset-securitization in size was challenging. Citibank succeeded and by 1989 the bank's Standard Credit Card receivables asset-backed securities, ABS, were by far the most successful in the world.

The key was that when customers failed to pay their credit card bills on time and the loans became non-performing, they were pulled out of the pools that made up the ABS and were replaced by new loans. That and other credit enhancements allowed credit card ABS to achieve high credit ratings. In subsequent years, much the same model has been used for a wide variety of loans, including in this decade the securitization

of subprime mortgages. The collapse of that sector spoiled things for everyone. Liquefying the balance sheets of banks became far more difficult, almost impossible at times, and that is why the Fed and Treasury launched the TALF. The legacy loan program will open up means other than ABS issuance for banks to raise capital by selling off unmarketable loans, especially mortgage loans And by bringing in Treasury co-investing and FDIC funding, pools of mortgage loans that are not eligible for Fannie and Freddie guarantee programs will become attractive again for the same type of sophisticated fixed-income portfolio management companies that have been active in the ABS market.

Legacy securities program: another shot at determining fair valuations

One thing market participants, especially veterans of distressed securities investment funds, have learned is that when bid-offer spreads are wide, transactions are sparse or even non-existent. That has been the case with toxic CDOs almost continually since July 2007. Recall again Fed Chairman Bernanke's response to Henry Kaufman's inquiry at the September 2007 meeting of the Economic Club of New York. Question: What would you have liked to have known about these complex securities before the crisis broke out? Bernanke's answer: "What these damn things are worth." That question remains unanswered.

Treasury's description of the legacy securities program emphasizes the need for price discovery: "The goal of this program is to restart the market for legacy securities, allowing banks and other financial institutions to free up capital and stimulate the extension of new credit. The resulting process of price discovery will also reduce the uncertainty surrounding the financial institutions holding these securities, potentially enabling them to raise new private capital." That optimism may be a little exaggerated. The reason is that there is no active secondary market in MBSs in general and CDOs in particular. As a result, different banks are able to mark-to-market their trading positions at wildly different prices. Some have written down the value of their holdings drastically, and they may be able to book higher earnings when fresh transactions validate higher prices than their current marks. However, other banks have barely marked their positions down at all. That makes a lot of banks allergic to the very idea of a "market determined price" that is well below their current valuations. At such a market determined price, their ability to raise private capital, already impaired, can only get worse. Hence, the relative enthusiasm banks may have for the legacy loan program is unlikely to be matched for the legacy securities program.

The mechanics are more complicated, too. In the legacy loan program, pools of loans are sold at auction. The legacy securities program does not involve auctions. Moreover, in the legacy loan program, all kinds of investors are welcome to participate in auctions and, if successful bidders, form funds. By contrast, in the legacy securities program, only the biggest and most successful of fixed-income securities managers, with USD 10 billion already under management in MBSs and CDOs, long performance records and demonstrated ability to raise upwards of USD 500 million from investors, will be eligible to become pre-qualified fund managers. The Treasury throws out 5 as the number of firms that will be chosen. Newcomers need not apply! Once pre-qualified, the idea is that the manager will raise equity capital from private investors to form special investment funds separate from the rest of their businesses. When they are successful – and the big firms will probably be able to raise substantial sums – the Treasury will top up the equity on a 50-50 basis. Treasury will also stand ready to add a comparable amount in the form of a loan to the fund (and in some cases double the equity amount as a loan). Then the manager will go out and start to buy distressed MBS assets. Treasury insists that the manager won't be a high-frequency trader: "It will predominately follow a buy and hold strategy."

But what if this doesn't provide enough leverage to promise attractive returns to either the investment fund or the taxpayer? Then the fund can go to the Fed, once the expansion of the TALF to include legacy securities is activated, and take advantage of Fed funding for purchases of securities under that program. In

other words, the Fed will play the role of "force multiplier" that the FDIC is playing through its guarantees on PPIP funds taking part in the legacy loan auctions.

LEGACY SECURITIES PROGRAM: TREASURY'S EXAMPLE

Step 1: Treasury will launch the application process for managers interested in the Legacy Securities Program.
Step 2: A fund manager submits a proposal and is pre-qualified to raise private capital to participate in joint investment programs with Treasury.
Step 3: The Government agrees to provide a one-for-one match for every dollar of private capital that the fund manager raises and to provide fund-level leverage for the proposed Public-Private Investment Fund.
Step 4: The fund manager commences the sales process for the investment fund and is able to raise $100 of private capital for the fund. Treasury provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the Public-Private Investment Fund. Treasury will also consider requests from the fund manager for an additional loan of up to $100 to the fund.
Step 5: As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities.
Step 6: The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. The Public-Private Investment Fund, if the fund manager so determines, would also be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.

Source: US Treasury Fact Sheet of March 23, 2009

How quickly can it work, if it works?

The answer is simple: even with the very encouraging response from some of the biggest fixed-income managers and hedge funds, there is a lot of red-tape that will delay the implementation of the legacy securities program. (There is plenty of red-tape in the legacy loan scheme, as well, but FDIC is capable of arranging prototype auctions in a fairly short period of time.) And even after the 5 fund managers are pre-qualified and find equity capital to fund the special investment vehicles that must be created, there is no assurance that banks will be eager to sell, unless they are compelled by their main regulator (the Office of the Comptroller of the Currency, OCC, for national-chartered banks, the Federal Reserve for state-chartered member banks) to clean up their balance sheets. Maybe that is the unspoken motivation of the entire plan, forcing the banks to admit that the securities they have been holding at much higher prices than private-sector investors will pay in today's marketplace have to be marked down drastically. That would restore a semblance of realistic pricing, but in the process would likely force the closure or merger of a lot of banks. Or else somehow the US government will have to come up with a new TARP from Congress in order to inject still more capital into banks unable to bear such balance sheet losses. Whether the enthusiasm for the Geithner plan will persist under such a scenario is unknown.

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