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THE TOXIC ASSET CLEANUP

BY HOWARD NEWMAN

For nearly two years, the Federal Reserve and the Treasury have been addressing the "toxic asset" problem plaguing our financial system without articulating what problem they are trying to solve and why the solutions being proposed will work.

When the financial crisis first emerged, it manifested itself in the subprime area. Holders of subprime paper scrambled to get out of it, either because they realized that it was seriously impaired from a credit perspective, or because mark-to-market losses triggered calls for more collateral. A massive liquidation began and much of that paper found its way back onto the balance sheets of the major banks and dealers. Banks and dealers, in turn, found themselves overleveraged due to the additional risk assets on their balance sheets, and then became capital impaired as they unloaded those assets at ever reducing prices.

When lending and asset bubbles unwind, the first reaction is to treat the problem as a liquidity issue. The paper is assumed to be creditworthy but market participants re-price liquidity at a premium as assets are sold at "fire sale" prices rather than fair market value. Regulators realize that the difference between these two values is huge — a good rule of thumb is 30% off. Given the leverage in the system, realizing these "liquidity" marks would be catastrophic. Initial solutions, such as the proposal to create a "Super SIV" were based on the premise that liquidity was the primary issue. If only someone would hold the assets, they would eventually pay off at prices much closer to par than the liquidity mark.

As this bubble unwound, a second concern arose. What if the problem were not liquidity, but rather credit, and eventual bank solvency? A simple analysis that had housing prices fall to affordable levels indicated that the correction would average at least 25%, and be much greater in the supercharged markets. Even if the paper were held to maturity, the banks and dealers would sustain losses they could not absorb from either earnings or capital.

Now there are additional problems. First, with credit markets frozen, there is a refinancing problem. Many long-term assets were financed with short-term liabilities on the assumption that these liabilities could be refinanced when due. These maturing obligations have to be re-priced to reflect their challenged status as well. More significantly, the recession now well under way is creating new classes of credit-impaired assets at an increasing rate. Today's good asset may be tomorrow's problem. Finally, there is some urgency to identify and isolate bad assets so new capital can be raised to repair the balance sheets of those banks that are solvent, but illiquid.

So it's appropriate to ask which of these problems the "public-private partnership" is designed to address. Is the Treasury looking for someone to own illiquid assets that are otherwise creditworthy? Provide refinancing to otherwise creditworthy borrowers? Recreate the shadow banking system with federal support? Work out problem credits? Speculate on the duration and depth of the recession? Recapitalize banks that have been cleaned up? Once a problem is identified, devising a solution and pricing the capital to provide it is not that challenging.

Raising private capital to warehouse good, but illiquid, securities so banks are freed to make new loans is straightforward. This is, after all, what distressed funds were set up to do. If additional funding is needed to leverage the returns to these partnerships, a model is already in place. The Treasury has already created programs to guarantee banks access to funds for the next three years at a cost that is close to the Treasury's borrowing rate. Negotiating appropriate returns on capital for what is essentially a low risk operation is doable.

In contrast, asking private capital to become workout departments or refinance a "good bank" is a labor intensive process, even when the economy is reasonably healthy. When I was involved in creating Mellon's good bank/bad bank structure in 1988, the due diligence and valuation work took more than six months. The parties involved had to be satisfied both that the "value" we placed on the "bad bank" assets was fair, given that there was no ready market for them, and that the earning power of the "good bank" would not be further compromised by the creation of a new set of challenged credits.

The government faced a far greater challenge during the initial phase of the savings and loan crisis when real estate markets were greatly stressed and asset values were not stabilized. In order to attract capital, the government provided income maintenance to new capital until the system sorted itself out. Over time, as the system healed, the government was able to negotiate increasingly better deals until, ultimately, it was paid premiums in later transactions.

There are elements of all of these problems in today's world. Halting forced sales at liquidity discounts is only part of the solution. Stabilizing the asset values underlying the toxic paper will also be required. And some protection against continued deterioration in the economy will be required so that private capital can understand the earning power of a recapitalized institution.

Recognizing that there are many problems to be solved and looking for a separate solution to each problem will be required to attract private capital.

Howard Newman is president and CEO of Pine Brook Road Partners LLC, a private equity firm that makes business building and growth capital investments in energy and financial services. He has been involved in refinancing four banks, including the "good bank/bad bank" recapitalization of Mellon.

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