

Market Update – March 28 – Geithner’s Plan

Part 1: Don’t Call Them “Toxic”

Treasury Secretary Geithner came up with a “new” plan to remove toxic assets from banks’ balance sheets. As a first step, Geithner apparently got his marketing people involved. He no longer refers to “toxic” assets. They are now known as “legacy” assets. There are two types of legacy assets:

1. legacy loans – real estate loans
2. legacy securities – securities backed by real estate loans

There is a different Plan for each (legacy loans and legacy securities). I have described each below (in Part 2). In support of the plan, I have told my children to stop referring to their potty activities as #1 and #2. It will now simply be known as “legacy food.”

Part 2: Legacy Loan Plan and Legacy Securities Plan

Legacy Loan Plan

1. Banks identify loans that they want to sell
2. FDIC will examine loans and determine the capital structure that the FDIC will guarantee. The FDIC will guarantee debt up to 6:1 (debt to equity).
3. FDIC auctions loans and they are sold to high bidder.
4. Buyer issues debt which is guaranteed by the FDIC.
5. Half of the equity is provided by the buyer and half is provided by the Treasury.
6. The buyer manages the assets.

Sample Numbers for Legacy Loan Plan (Provided by Treasury)

1. Imagine a high bid of \$84 for a \$100 face value loan.
2. The public – private pool will be financed with \$72 of debt and \$12 of equity (6:1).
3. The \$12 of equity is provided by the buyer (\$6) and the Treasury (\$6).
4. The debt is guaranteed by the FDIC and is non-recourse. This means that the buyer only has \$6 at risk.

The Legacy Securities Program

1. Treasury Department will select at least five Fund Managers.
2. A selected Fund Manager will raise capital.
3. Once the capital is raised, the Treasury will invest an amount equal to the capital raised by the Fund Manager. This money will come from the Term Asset Backed Securities Facilities (TALF). This is a major change in the TALF program (which was supposed to be used for newly issued securities, not existing securities).
4. The Treasury will loan an amount equal to the Treasury's equity investment.
5. The Treasury will consider an additional loan (equal in amount to the first loan amount).

Legacy Securities Program Sample Numbers (Provided by Treasury)

1. Fund Manager raises \$100 that can be used to buy securities. This is equity.
2. Treasury adds \$100 equity investment.
3. Treasury automatically approves \$100 loan and will consider an additional \$100 loan.
4. Result is that the fund can buy either \$300 or \$400 of securities.

The Size of the Problem

1. America's ten largest banks have \$3.6 trillion of legacy loans – approximately 1/3 of their assets. These are NOT marked to market. They are carried at cost. It is estimated that these loans are carried at 3% higher than their market value. This amounts to \$110 billion. If that is written down, that would wipe out ¼ of the tangible common equity of the top ten banks. (Source: Economist.com)
2. The top ten banks have \$3.7 trillion of securities. These are marked to market and have been the main source of write-downs. For the top ten banks, 16% of securities were classified as Level 3 (meaning their valuation is based on the bank's model and this may be optimistic). This is 1.5 times their equity. The banks use models to value Level 3 assets.
3. Level 3 assets as a percentage of tangible common equity (pointing out a risk that the bank's capital may be overstated):
 - a. Morgan Stanley ~300%
 - b. C, WFC, GS, MPM ~150%
 - c. BAC ~110%
4. CreditSights projects collective losses of the four biggest US banks through the end of next year could be anywhere from \$250 billion to \$450 billion.
5. Estimates are that it will take \$1 - \$2 trillion to clean balance sheets. Treasury does not have that amount available. Congress is unlikely to approve this after the AIG debacle.
6. This program will likely remove \$500 billion of legacy assets from the banks' balance sheets. Realize that last week, the Fed also said it would purchase \$1.2 trillion of Treasuries and MBS.
7. The government's equity investment comes from the TARP. If the Treasury spends \$100 billion, they probably have \$52.6 billion left (but we don't know for sure). This will be leveraged by debt from FDIC (for loan purchases) and Fed's TALF (securities).

Part 3: The Effects of Non-Recourse Debt

Imagine that you have 100 pools of loans. Each pool has loans with a face value of \$1 million. You expect half to be worth 80 cents on the dollar and the other half to be worth 40 cents. You don't know which will be worth 80 and which will be worth 40. You plan on bidding on all 100 pools. As a result, the entire group should be worth \$60 million.

This pools will be financed with \$6 debt and \$1 of equity. The equity will be 50 cents from the investor and 50 cents from the Treasury. As a result, the investor only puts in 7.14% of the investment (50 cents / \$7).

With non-recourse loans, however, you will be willing to bid much more than \$60 million. The loans that are worth 40 cents will end up being worth zero to the investor. He will lose 7.14% on each of the 50 pools that end up worth 40 cents on the dollar.

To break even, the investor needs to earn 7.14% on the other 50 pools. That means that these pools are worth \$68.57 to them. If they bid \$68.57 for these pools, they will lose their \$5.71 (7.14% of \$68.57) equity investment on half the pools and make \$5.71 on the other half. The reason that they will make \$5.71 is that there will be \$11.43 gain on the \$68.57 investment. Half of the gain will go to the Treasury and half will go to the investor.

Think about this! We have a series of pools that are worth \$60 million. But, we were able to bid \$68.57 million for them. It's magic!

Of course, there's no such thing as magic. On the fifty pools that turned out to be worth \$40 (but the investor bid \$68.57 for), the investor only put in \$5.71. The government put in \$62.86. The government lost \$22.86.

In this example, there was a wealth transfer. The bidders over-bid (\$68.57 vs \$60) for the 100 portfolios. The \$8.57 million was a wealth transfer from taxpayers to banks. It could also be argued that it is a wealth transfer from good banks to bad banks (because the FDIC will be a loser). Personally, I believe that the FDIC will eventually come back to Congress and the taxpayer will bear this cost.

The government's loss could also be seen in another way. In 50 of the pools, the Treasury will make \$5.71 (for a total gain of \$285.71). On the 50 pools where they lose \$22.86, the total loss is \$1,143. The difference between the \$1.143 loss and the \$285.71 gain is the \$857 loss.

The investor's profit would be increased by bidding lower. In addition, if the difference between the good pools and bad pools is larger, there is more loss incurred by the Treasury.

Part 4: The Government's Intent

Principles of the Plans (According to Treasury):

1. Leverage the government's investment – by attracting private capital, government gets most bang for its buck.
2. Share risk with private sector.
3. Use private sector to help in price discovery – reduce the likelihood of the government overpaying.
4. FDIC will provide oversight to the Legacy Loan Program.

Goals of the Programs (Per the Treasury)

1. If we remove the questionable loans and securities, banks will be able to attract more private capital and will be able to start making loans again.
2. The Treasury Department's white paper on this program says that this program should help to reduce the excessive liquidity discounts embedded in legacy asset prices.

Geithner's Comments

1. Geithner wrote a piece in the WSJ and blamed the current crisis on the fact that we all were overleveraged. He wrote that "as a nation, we borrowed too much and let our financial system take on too much risk." (I think that's his way of saying that this is everyone's fault, so we're all going to pay for it.) Then, he explained how he was setting up these leveraged funds to solve the problem. Am I the only one who thinks that this is hilarious?
2. Geithner also wrote that the public – private partnership will insure that participants share the risks along the taxpayer, and that the taxpayer shares in the profits from investments. Who is he kidding? (Okay, I know who he's kidding – the idiot public.) If I do a deal with you and you put up 7% of the capital and I put up 93% of the capital and we share the profits, I'm not going around telling people that we're sharing the risks.
3. Geithner also said that private investors help protect the government from overpaying and will help the price discovery process. If I could have kept a straight face while saying crap like this, I would have done a lot better in bars as a single man. We are subsidizing the private investor with a non-recourse loan. (See my example above.) The result is that the private investor has little capital at risk and can overbid. These are not legitimate prices – these are subsidized transactions.
We wouldn't be in this mess today if mortgage loans were made with recourse. Non-recourse loans had a huge impact on homebuyers' willingness

to take risk. You take risk with other people's money. Interestingly, we're seeing non-recourse loans reappear.

4. Geithner has said that we need to eliminate the liquidity discount that exists in the market. This is a bold statement from someone who really doesn't know. None of us know. Prices could be low because of liquidity issues or because these securities are crappy (and may be worth even less). I have no idea which one it is. But, I believe that there are enough smart long-term investors in the market that would have been buying these securities if this was clearly just an illiquidity discount that would result in excess returns.

Part 5: Who Will Participate

The Overriding Problem

1. Banks are reluctant to sell these assets for a variety of reasons:
 - a. They think that the assets are undervalued
 - b. If the assets have not been marked down, selling at a low price will force them to recognize a loss
 - c. Selling at a loss will force the banks to raise more capital
2. While some securities are carried at market value (and already written down), loans (and some securities) are not
 - a. They are classified as “held to maturity”

Why This Program is Attractive to Private Investors

1. The debt used is non-recourse – meaning that all the private investor could lose is his equity investment
2. The private investors are being allowed to use large amounts of leverage
3. The government has indicated that the financing will match the term of the underlying assets. This will eliminate the refinancing risk.
4. The Treasury Dep’t has promised investors that they will not be subject to compensation limits that have been placed on firms participating in the TARP bailout
5. The government seems to be assuring private investors that they will not be blamed for making large profits, nor will they be called to testify before Congress

Who Will Participate

BlackRock and Pimco said that they would participate as buyers. Legg Mason is also expected to participate. All three are also likely to start closed-end funds which will allow individuals to participate. This may help politically – it could lessen the argument that the government is simply benefiting hedge funds.

Closed-end funds are perfect for illiquid assets. When shareholders sell, they are selling to other investors. The fund itself does not shrink (and have to sell the underlying asset). This is in contrast to an open-end mutual fund.

BlackRock and PIMCO are excited about this deal. There’s no surprise. The fact that they get term financing means that investors will earn the return of the asset relative to the cost of funding (without risk of refinancing).

Why the Banks Will Want to Participate (Per Geithner)

1. Banks will want to get rid of these assets because they create too much uncertainty on their capital and the uncertainty makes it difficult to raise money.
2. As a result, the banks will be willing to sell at a discount.
3. Without the prospect of future losses, private capital will return to bank or Treasury will help recapitalize the banks.

More Likely Reasons That the Banks Will Participate

1. Sheila Blair is saying that the decision as to whether to sell assets will be made by banks “in conjunction with regulators” – so there may be pressure to sell these assets. (The FDIC wants involvement in order to maintain their regulatory power.)
2. Buyers are going to be able to offer much higher price because of the leverage and non-recourse nature of the loans. (But sellers are still going to have to come down in price.)
3. Banks which have already taken write-downs will be more willing to sell. Some analysts have included JPM, WFC, PNC, First Horizon and Synovus in this group. Similarly, some theorize that Citi and BAC will not want to sell because they have government guarantees on some of their assets.
4. Banks may be anxious to sell some of their better assets so that they can use these sales to justify higher market values.

We Are Left With Some Key Questions

1. Will banks be willing to sell for low amounts, just in order to start over?
2. If banks do sell, will they be able to raise more capital?
3. If banks raise more capital, will they actively make loans?

Part 6: Who Wins and Who Loses?

The Key Issue: Liquidity Discount or True Impairment

1. The key to what you think of the plan depends on whether you think:
 - a. The troubled assets are being underpriced by the market due to fear;
or
 - b. The assets are truly impaired
2. The government believes that this is a liquidity issue. Therefore, they are simply trying to close the gap between the intrinsic value of the assets and the market value.
3. This plan will probably work if this is a liquidity issue (temporary undervaluation). If not, this is a wealth transfer from taxpayers to the banks. In the process, there will also be a transfer to the private investors.
4. On the other hand, some people argue that this is simply Paulson's "cash for trash" plan. They disagree with Geithner's assumption that this is a liquidity issue and he can use taxpayer money to bid the prices back to normal levels.
5. There's still a lot of uncertainty about this program. For instance, we don't know the cost of funding (interest rates) on the debt. We don't know the cost of the FDIC debt guarantee (although I have to believe that it will be very small). Similarly, we don't know about the auction process. It surprised me that this plan was released without every single detail being worked out.

Who Wins?

1. The banks win. If this plan works, the banks will avoid nationalization. In effect, the government is helping banks to repair their balance sheet. In addition, the banks will be selling assets for more than they are worth (due to the government subsidy).
2. Maybe taxpayers will win? Taxpayers could profit if assets appreciate. It's hard for me to believe that the banks are going to sell assets for prices that are this low. While some assets will do well, the government will be the loser due to the non-recourse loans on the assets that do poorly.
3. If this doesn't work, we all lose. We need this to work. If it doesn't, the Administration will lose a lot of credibility. In that case, we will all lose.

Part 7: Positives About this Plan

1. The plan gives us more detail than we originally had.
2. If the banks are insolvent, this is being determined by private investors
3. The government is not managing the assets.
4. This may result in eventual nationalization and the administration could say that this was the result of private forces.
5. We are avoiding the distressed asset sales that would occur if the banks were put into receivership.
6. The market had a huge rally on the news of this plan. It's possible that the market really liked this news. (It's also possible that the market was rallying due to the public sentiment that turned against the idea of imposing a special 90% surtax on the AIG employees. In addition, during this entire crisis, we've always seen the market rally when there was evidence that the government was going to bail out shareholders.)

Some people have argued that the \$700 billion increase in stock prices covers the cost of the program. The problem is that taxpayers will pay for the program and shareholders will benefit from the increase in stock prices.

Part 8: Criticisms of the Plan

1. Heads I Win, Tails You Lose. If the assets do well, the public-private partners make money and FDIC gets paid back. If assets default at a high rate, Treasury and private investors are wiped out. The FDIC would get the securities and sell them. FDIC loses because of the inflated price (due to the non-recourse loans) in the initial transaction (in other words, FDIC takes the risk). This is a bailout and the taxpayers will lose.
2. FDIC is in the business of insuring deposits. Now, they're going to insure new entities – public-private investment funds. The FDIC is no longer protecting the integrity of their insurance fund.
3. Does the FDIC have enough funding?
4. We are creating a subsidy for the private investors. The subsidy has two forms: (A) their ability to borrow at a low rate which does not reflect the riskiness of the MBS cash flows; and (B) the non-recourse nature of the debt (effectively creating a call option for the buyers). Taxpayers will suffer through higher rates (due to more government debt).
5. It's impossible to think of this process as leading to fair pricing. The government is subsidizing bids through non-recourse loans.
6. The Administration wanted to avoid Congressional oversight. Rather than asking for more money, they used the FDIC and the Fed. Later, this will force the Congress to supply more money.
7. If the government is guaranteeing long-term, low interest rate loans, they may have interest rate risk (unless they are simply financing this by issuing debt which matches the duration of the loan).
8. The biggest mistake we have made has been ruling out debt for equity swaps. We've basically said that banks can't fail. So banks don't need to worry – no rush to get anything done. Banks have been effectively given the option to hold on to these loans and securities.
9. Another mistake we made was when the gov't turned the AIG bonuses into a big deal. While these bonuses were offensive, the government was calling attention to its inability to manage this process and it made it much more difficult for them to go back to Congress for funding. As a result, we have been forced into this plan.
10. We are doing this transaction in a complicated way so that taxpayers don't understand it.
11. If these assets are undervalued, why do we want to share the profits with hedge funds? (The government argues that they want pricing information, yet the pricing information is flawed due to the non-recourse loans.)
12. What if only the best of the bad assets are bought? Banks will be left with the real crap.
13. Unlike receivership, banks will be left with some bad assets on their books. It's possible that they will be left with a substantial amount of these.

14. Non-recourse mortgage loans are what got us into trouble in the first place. Now, we're repeating this mistake in a misguided attempt to get out of this problem. We're delaying the inevitable losses. The government is basically gambling that things will get better.
15. This scheme might make recapitalization seem less important to the government. It might also make recapitalization more unpopular among taxpayers and congress.
16. Do we want to have mortgages in the hands of hedge funds? How are they going to deal with bad borrowers?

Future Concerns (Even if this Plan Works...)

1. Even if this plan works, there are assets in off-balance sheet vehicles that banks may have to bring back onto their books. The four biggest US banks (BAC, C, JPM, WFC) have about \$5.2 trillion of off-balance sheet assets. These are mortgages, credit card debts and auto loans.

In annual report, JPM said it may have to bring back \$160 billion of assets. C said \$179 billion. Most will be credit card (\$92B at C and \$70B at JPM; \$114B at BAC).

2. What will happen when the gov't stops lending? Will the price of these legacy assets fall?
3. We don't know if the securitization market is permanently impaired. The assets are difficult to value and people have been burned.
4. Is a market made better by bribing / subsidizing investors to participate?

Part 9: Alternative Strategies

1. Some people wonder if we should just give banks more capital – it would be a more direct process than helping hedge funds to profit.
2. Government could also agree to absorb losses on assets above a certain level. This would require no upfront investment. If the assets are really worth more than their current value, there will be no losses to absorb. Government has already agreed to absorb losses on \$300 billion of Citi assets and \$100 billion of BAC assets.
3. We could try to improve the current plan by trying to do more than just subsidize the buyers. A better plan would allow banks to share in the upside – so that they have incentive to participate.
4. We could convert some of the debt into equity and very quickly make the banks well capitalized again.

Part 10: Conclusion

The government has a fundamental problem: the banks have losses and the government wants to hide the fact that we are transferring taxpayer assets to these banks. As a result, the Geithner plan is a complicated process designed to make it appear as that we are investing alongside private investors on an equal basis. Nothing could be further from the truth. We are subsidizing the buyers.

We are currently dealing with a large gap between the amount that the banks think these assets are worth and the amount that investors are willing to pay. The way that the government is bridging this gap is through the use of a subsidy. The gap is not magically disappearing. In addition, the price discovery (that the Treasury Department claims is occurring) is a sham.

With all that said, I'm not convinced that it will fail. I believe it will be more costly than it needs to be and that the cost will be incurred by the wrong people.