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INVESTING

Toxic-Asset Plan: Tricky Times Ahead

By David Bogoslaw

The Treasury's program to cleanse bank balance sheets may be hampered by banks' unwillingness to pony up bad loans—and investors' fears of political risk

Treasury Secretary Timothy Geithner's long-awaited public-private investment program, announced on Mar. 23, has fueled hopes that it will solve one of the most nettlesome problems of the financial crisis: reasonably pricing illiquid assets and getting them off banks' balance sheets once and for all.

But the plan may not be the slam-dunk hoped for by the market. The only clear beneficiaries at this point appear to be the handful of asset managers to be picked by the government to oversee the sale of the toxic "legacy" securities that have dogged U.S. banks since the start of the housing downturn.

Indeed, though the plan was received rapturously by Wall Street on Mar. 23, with major stock indexes shooting higher by nearly 7%, some critics are saying they don't see the PPIP as a silver bullet that will get credit flowing again soon. If anything, the events on Capitol Hill of the past couple weeks—including the AIG (AIG) bonus controversy—may make it that much more difficult for potential investors to get on board.

UNCLE SAM FACES THE MOST RISK

An earlier plan for the Bush Administration to use Troubled Asset Relief Program (TARP) money to directly buy illiquid assets off the banks' balance sheets ran aground amid worries that taxpayers would end up overpaying for the assets. That's still a possibility some warn, since the government is taking on the lion's share of the downside risk by being willing to put up half the equity investment and up to six times leverage to buy legacy loans. The Treasury is willing to put up $75 billion to $100 billion of the remaining TARP funds to help pay for these assets.

The benefit of the program is that to the extent private money is profitable, Uncle Sam's money will be profitable and it's a way to recoup part of the money the government is providing, says Dan Alpert, managing director of Westwood Capital, an investment bank in New York.

There are certain to be some banks that would end up being undercapitalized if they sold their assets at a true markdown, and it's to be expected that they will try to resist that as much as possible, he says. "It's going to take as much pressure by regulators to say

'We'll either seize you or recapitalize you if you're a bank that's too big to fail,'" he says.

RISK OF OVERPRICING

The legacy loan program will probably need some inducement from regulators such as the Federal Deposit Insurance Corp. (FDIC) since banks won't readily allow loans to come to market that have the potential to put the bank's balance sheet underwater, he adds.

And even using a government-assisted market mechanism to set prices, there's still a real risk of overpricing simply because investors are likely to be willing to pay more for assets with all the government leverage available than they would in a normal market environment, says Alpert.

"The check on this whole structure is that private capital and public capital are *pari passu*—side by side," with neither side getting preferential treatment, he says. If the leverage encourages people to overbid, that tendency is likely to be tempered by investors' realization that they'd be putting their private equity at risk.

The foremost obstacle in people's minds is the political risk of taking money in any form from the government. As the parade of Congressional hearings in which CEOs of big-name TARP recipients hauled up for interrogation attests, would-be investors know what they can expect if the public-private investment program doesn't deliver on the promise of cleansing banks' balance sheets, or worse, delivers too much profit for big investors. The rush by Congress to tax 90% of bonuses doled out to certain AIG execs has investors running scared.