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Are Bailouts Part of the Problem?

By Cyrus Sanati

As the Treasury Department continues to hammer out the details of its plan to buy toxic assets from troubled banks, some on Wall Street are questioning the government's entire strategy in combating the financial crisis, saying that it has just delayed the inevitable.

One of these critics is Daniel Alpert, the managing partner of Westwood Capital, who argued in a note to clients Wednesday morning that the government money and new equity being thrown at the banks have caused them to put off revaluing the trillions of dollars worth of whole loans on their books — loans he believes are being carried at unrealistically high valuations.

Thus far in the crisis, banks have mainly written down the value of securitized products that were backed by pools of loans including mortgages. Accounting rules generally forced financial institutions to take multibillion-dollar hits to their balance sheet by marking down the value of those securitized products to market prices.

But banks aren't required to write down the trillions of dollars in whole loans on their books, because they are classified as being "held to maturity." As such, they can keep the full value of the loan on their books until the loan term ends — or the borrower defaults.

The big concern for Mr. Alpert is that the banks are not being realistic in their valuation of those whole loans, and that all the government cash is masking the banks' vulnerability to deteriorating loan values.

"The capital provided by the government through TARP, etc. has allowed the banks to continue holding deteriorated assets at values far in excess of their true market value," Mr. Alpert said in his note. Later, he added: "It is unrealistic to believe that home or commercial real estate values are destined to recover any meaningful portion of bubble-era pricing."

Consider the example of a person who bought a house in Phoenix in 2007 with a $400,000 mortgage from a bank. By 2009, the market value of the home may have fallen to $200,000. Instead of repaying a mortgage worth twice the house, the homeowner defaults on the loan and mails the keys back to the bank.

Up until the point the bank forecloses on the house, the bank can carry that whole loan on its books at $400,000. When the bank finally sells the house for, say, $180,000, then it will record the loss.

Mr. Alpert contends that this scenario could be repeated for years to come unless the banks mark down the value of their whole loans. The result, he says, might be a slow and painful death, as lenders take small losses again and again.

More broadly, Mr. Alpert raises the possibility of an American version of the Ushinawareta Junen, or "lost decade" — a reference to the years in Japan following that country's real-estate-led banking bust in the 1990s, which was characterized by low growth and high unemployment.