Banks' Toxic Assets Still There: The Accounting Cannot Be Trusted

By Dirk Van Dijk on August 12, 2009

The Congressional oversight panel (COP) of the TARP program is just out with its August report (http://cop.senate.gov/documents/cop-081109-report.pdf). In it, it warns:

"Treasury's choice to pursue direct capital purchases resulted in a notable stabilization of the financial system, and it allowed the write-down of billions of dollars of troubled assets and reserve building. But, it is likely that an overwhelming portion of the troubled assets from last October remain on bank balance sheets today.

"If the troubled assets held by banks prove to be worth less than their balance sheets currently indicate, the banks may be required to raise more capital. If the losses are severe enough, some financial institutions may be forced to cease operations. This means that the future performance of the economy and the performance of the underlying loans, as well as the method of valuation of the assets, are critical to the continued operation of the banks.

"For many years, banks were required to mark their assets to market, meaning they listed the value for many assets based on what those assets would fetch in the marketplace. In response to the crisis, banks have been allowed greater flexibility in the way they value these assets. In most cases, we would expect the new rules to have permitted banks to value assets at a higher level than before. So long as they do not sell or write-down those assets, they are not forced to recognize losses on them.

"The uncertainty created by the financial crisis, including the uncertainty attributable to the troubled assets on bank balance sheets, caused banks to protect themselves by building up their capital reserves, including devoting TARP assistance to that end. One by-product of devoting capital to absorbing losses was a reduction in funds for lending and a hesitation to lend even to borrowers who were formerly regarded as credit-worthy.

"The recently conducted stress tests weighed the ability of the nation's 19 largest bank holding companies to weather further losses from the troubled assets and assessed how much additional capital would be needed. However, the adequacy of the stress tests and the resulting adequacy of the capital buffer required for future financial stability depend heavily on the economic assumptions used in the tests. As more banks exit the TARP program, reliance on stress-testing for the economic stability of the banking system increases."

In other words, much of the improvement we have seen in the banking system, particularly among the big 19 stress-tested banks - such as **J.P. Morgan** (JPM: 42.21 +0.97 +2.35%), **Goldman Sachs** (GS: 163.76 +4.54 +2.85%) and **U.S. Bank** (USB: 22.02 -0.08 -0.36%) - has come from changes in the accounting rules, rather than a change in the fundamental economic value of the securities. There has been some real improvement in the condition of the banks, but that is mostly due to the large round of capital raising in the wake of the stress tests.

The decision to inject capital rather than buy up the assets was a much more effective use of the TARP funds to stabilize the banking system, but it has left the fundamental problem in place: billions and billions of loans that were made that are unlikely to be paid back. The changes in the accounting rules allow the banks to extend and pretend that the loans still have a much higher value than they really do. This buys the banks some time.

A very steep yield curve does help the banks earn their way out of the mess they are in. After all, the basic economic function of a bank is to borrow short-term (take in, say, checking deposits) and lend long-term (say, a mortgage or a Commercial and Industrial term loan). The bigger the spread between short-term interest rates and long-term interest rates the bigger the net interest margin that banks can earn, provided that the long-term loans are actually paid back.

While the stress tests indicate that the big banks should be able to weather the storm (look at their performance under the "more adverse" scenario, not the base case, which was very optimistic). However, there are some very serious concerns about small and mid-sized banks, many of which made very big bets on commercial real estate lending, which is now going sour in a big way.

“If the economy worsens, especially if unemployment remains elevated or if the commercial real estate market collapses, then defaults will rise and the troubled assets will continue to deteriorate in value. Banks will incur further losses on their troubled assets.

“The financial system will remain vulnerable to the crisis conditions that TARP was meant to fix.

“The problem of troubled assets is especially serious for the balance sheets of small banks. Small banks‘ troubled assets are generally whole loans, but Treasury‘s main program for removing troubled assets from banks‘ balance sheets, the PPIP, will at present address only troubled mortgage securities and not whole loans.

“The problem is compounded by the fact that banks smaller than those subjected to stress tests also hold greater concentrations of commercial real estate loans, which pose a potential threat of high defaults. Moreover, small banks have more difficulty accessing the capital markets than larger banks. Despite these difficulties, the adequacy of small banks‘ capital buffers has not been evaluated under the stress tests.”

I continue to think that stress tests should simply become a routine part of the bank examination process, and should be done for all banks and on an annual basis. This would give investors more information about the condition of the banks they might be invested in, and economists more knowledge of the true state of the banking system on an ongoing basis. It would also be a far-less-sensationalized approach than the one-time stress tests conducted with great fanfare like the ones held this spring.

While individually none of these small and mid-sized banks pose a threat to the overall banking system, collectively they do. The FDIC is essentially out of its immediate funds and is drawing on “loans” from the Treasury. There is a big question in my mind if these loans will ever be paid back. To pay back the loans (the credit line is a huge $500 billion, but to tap more than $100 billion there are a number of hoops the FDIC has to jump through) and to rebuild the fund to normal levels will require large increases in the deposit insurance rate for several years.

It means that more prudent banks will have to pay for the sins of the imprudent banks, which is not exactly fair, but it is more fair than the taxpayers having to pay. Essentially this will amount to a tax on the banking system, and should help restrain the profitability of the banking system for a long time to come.

It now appears that the decision to use the TARP funds to directly inject capital into the banking system rather than to buy up the toxic assets was the right one. The second plan to buy up the bad assets, the PPIP program, has not gotten off the ground, and appears permanently stalled. The reason appears to be from a lack of sellers, not from a lack of willing buyers. As long as the banks do not have to write down the value of the securities, then they have no incentive to sell them at less than what they are carrying them for on their books, even if the value on their books is purely fictional.

I simply cannot trust the accounting at the banks. Putting money into a company where you cannot trust the accounting is a gamble, not an investment. Yes, there are gambles that pay off, and anyone who bought just about any big bank at the depths of the crisis has made out like a bandit. Even the government has done OK on the TARP funds that have been repaid - not nearly as good as any private investor, but it has still made a profit.

The annualized rate of return for the government has been running at about 20% as the TARP funds get repaid. Private investors in the banks have doubled and tripled their money off the bottom. If the Treasury under Hank Paulson had decided to actually bargain on behalf of the taxpayers rather than make the investments a thinly disguised gift to his old comrades, the government could have made a bundle - and a serious dent in the budget deficit.

In short, the problem with the toxic assets is still out there, and it is still a major risk to the economy. However, the steps that have been taken have stabilized the situation so that those assets will turn out to be a persistent drag on the economy for a long period of time, rather than dragging it under in a cataclysmic implosion, as appeared quite possible just a few months ago.

http://www.dailymarkets.com/stocks/2009/08/11/banks-toxic-assets-still-there-the-accounting-cannot-be-trusted/