

The great unwind and the new reality

By Michael Hart
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Over the past several months, there has been an unprecedented downward spiral in the fortunes of major commercial and investment banks that has shaken the financial system and pushed the economy into the worst recession in decades.

We are clearly witnessing the profound and painful change of our financial system as it undergoes violent consolidation, deleveraging and risk re-pricing. Currently, entire sectors of the financial industry (real estate, private equity, hedge funds) are recalibrating business models to respond to tightened credit and falling asset values and a protracted economic downturn.

We have previously seen tightened credit induced recessions follow periods of debt driven asset bubbles. The problems now experienced by banks are somewhat analogous to the late '80s early '90s Savings and Loans crisis, where balance sheets were plagued with poorly written, and illiquid credits funded on thin capital basis and mismatched long term asset / short term liability structures. However, the difference this time around is more dramatic, because some of the largest and most systematically significant financial institutions have failed or are surviving on government funding. This in turn has created great dislocation across global markets with resulting investor fear along with lower risk tolerance.

The rapid and sweeping fall of these firms resulted from a domino effect of complex capital market reactions. Much of the negative outlook initially was based on inherent flaws

in bank balance sheets stuck with assets targeted for securitization, and weighed down with default risk instruments based on credit (Credit Default Swaps: CDS). In 2008, major



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investment banks became targets for short sellers due mostly to mounting losses from soured residential mortgage loan pools that could potentially exceed their capital base. Some investment banks were merged into stable deposit based banks or received third party equity infusions.

In September 2008 Lehman Brothers, which reportedly had the most significant Mortgage Backed Securities (MBS) exposure to capital ratio, was allowed to fail. This bankruptcy brought to light the enormous size of contingent liabilities in the form of the CDS market (insurance policies on bonds). The Lehman bond default triggered the AIG selloff (that had provided insurance on CDS) which resulted in a lowering of AIG credit ratings.

The US Government finally had to provide AIG additional investment to backstop its CDS obligations. The Lehman bankruptcy leading to the effective AIG nationalization sent a shockwave through the markets: the credit market virtually froze as bank settlements were challenged due to perceived counterparty risks illustrated in the rapid demise of Lehman and AIG. This forced banks to hoard cash and substantially reduce credit in

order to preserve capital until existing toxic assets values can be established and positions liquidated. The lack of credit exacerbated the already slowing economy and was the proximate cause of the plunge of almost 4% in the fourth quarter GNP.

Much like a doctor who prescribes stronger doses for a deteriorating medical condition, the Fed and Treasury have been using increasingly more powerful methods to counteract the effects of the credit crisis. Initially under the Bush administration, they used only ad hoc treatments. A major action was the infusion of most of the first \$350 billion from the Troubled Assets Relief Program (TARP) directly into bank preferred equity to enhanced capital ratios. This temporarily had a stabilizing effect on the bank stocks.

However, the underlying problem of toxic loan portfolios has still not been dealt with. Therefore, the ultimate goal of lowering credit spreads and igniting new lending remains elusive. More recent policy antidotes have included guaranteeing debt obligations and buying mortgage paper in order to induce private credit to begin flowing again. The Fed has more than doubled its balance sheet to provide liquidity to the system. The Treasury under the Obama administration is expected to administer the second \$350 billion TARP tranche with more comprehensive prescriptions to resume normal capital market functions. This will offer a solution to bring liquidity to the banks balance sheets and will continue to backstop institutions in order to mitigate the effect of diminished capital due to asset value

write-downs. In addition, a fiscal stimulus in the amount of some \$800 billion is pending.

However, the damage to the economy from the credit seizure is not done. As the recession runs its course, credit quality will get worse before it gets better. Lenders portfolios, which are already stressed, are now faced with credit issues that have widened out to commercial real estate, consumer debt and higher leveraged corporate debt markets.

The recovery period will be prolonged as the underlying problem of troubled residential values and credit will now be exacerbated by the recession. The great unwind of leverage in the system will be painful as investments of all types continue to get repriced and re-margined to reflect the new cost of capital and economic reality. This loss of leverage and dampening demand is having a “deflationary” impact on the economy as evidenced by the drop in energy costs. The ultimate recovery may offer an increase in valuations fueled by massive Federal intervention which Keynesians believe has an inflationary effect.

The coming era will likely usher in a new reality that will likely include more transparency, regulation, disclosure, higher equity capital ratios, and retention of first loss risk for securities issuers. While there will be lots of pain for many to get there, the upside of all this change should result in an extended period of more moderate and sustainable asset values. In the real estate sector, once liquidity is restored senior lenders will be re-zoned into the comfortable sub-65 percent loan-to-value band of the capital stack. This will likely require more structure to transactions as borrowers scramble for “gap capital”.

Clearly more equity will be required. Also mezzanine debt, long considered high leverage in nature will evolve to “middle of the stack” capital. As we all await a return of normalcy to capital markets, the new ground rules for capitalizing assets with a significant structure will likely require greater use of investment bankers and mortgage brokers in the new world.

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