

The Fall of the Toxic-Assets Plan

By Lucian Bebchuk

The plan for buying troubled assets — which was earlier announced as the central element of the administration's financial stability plan — has been recently curtailed drastically. The Treasury and the FDIC have attributed this development to banks' new ability to raise capital through stock sales without having to sell toxic assets. But the program's inability to take off is in large part due to decisions by banking regulators and accounting officials to allow banks to pretend that toxic assets haven't declined in value as long as they avoid selling them.

The toxic assets clogging banks' balance sheets have long been viewed — by both the Bush and the Obama administrations — as being at the heart of the financial crisis. Secretary Geithner put forward in March a “public-private investment program” (PPIP) to provide up to \$1 trillion to investment funds run by private managers and dedicated to purchasing troubled assets. The plan aimed at “cleansing” banks' books of toxic assets and producing prices that would enable valuing toxic assets still remaining on these books.

The program naturally attracted much attention, and the Treasury and the FDIC have begun implementing it. Recently, however, one half of the program, focused on buying toxic loans from banks, was shelved. The other half, focused on buying toxic securities from both banks and other financial institutions, is expected to begin operating shortly but on a much more modest scale than initially planned.

What happened? Banks' balance sheets do remain clogged with toxic assets, which are still difficult to value. But the willingness of banks to sell toxic assets to investment funds has been killed by decisions of accounting authorities and banking regulators.

Earlier in the crisis, banks' reluctance to sell toxic assets could have been attributed to inability to get prices reflecting fair value due to the drying up of liquidity. If the PPIP program began operating on a large scale, however, that would no longer been the case.

Armed with ample government funding, the private managers running funds set under the program would be expected to offer fair value for banks' assets. Indeed, because the government's funding would come in the form of non-recourse financing, many have expressed worries that such fund managers would have incentives to pay even more than fair value for

banks' assets. The problem, however, is that banks now have strong incentives to avoid selling toxic assets at any price below face value even when the price fully reflects fair value.

A month after the PPIP program was announced, under pressure from banks and Congress, the U.S. Financial Accounting Standards Board watered down accounting rules and made it easier for banks not to mark down the value of toxic assets. For many toxic assets whose fundamental value fell below face value, banks may avoid recognizing the loss as long as they don't sell the assets.

Even if banks can avoid recognizing economic losses on many toxic assets, it remained possible that bank regulators will take such losses into account (as they should) in assessing whether banks are adequately capitalized. In another blow to banks' potential willingness to sell toxic assets, however, bank supervisors conducting stress tests decided to avoid assessing banks' economic losses on toxic assets that mature after 2010.

The stress tests focused on whether, by the end of 2010, the accounting losses that a bank will have to recognize will leave it with sufficient capital on its financial statements. The bank supervisors explicitly didn't take into account the decline in the economic value of toxic loans and securities that mature after 2010 and that the banks won't have to recognize in financial statements until then.

Together, the policies adopted by accounting and banking authorities strongly discourage banks from selling any toxic assets maturing after 2010 at prices that fairly reflect their lowered value. As long as banks don't sell, the policies enable them to pretend, and operate as if, their toxic assets maturing after 2010 haven't fallen in value at all.

By contrast, selling would require recognizing losses and might result in the regulators' requiring the bank to raise additional capital; such raising of additional capital would provide depositors (and the government as their guarantor) with an extra cushion but would dilute the value of shareholders' and executives' equity. Thus, as long as the above policies are in place, we can expect banks having any choice in the matter to hold on to toxic assets that mature after 2010 and avoid selling them at any price, however fair, that falls below face value.

While the market for banks' toxic assets will remain largely shut down, we are going to get a sense of their value when the FDIC auctions off later this summer the toxic assets held by failed banks taken over by the FDIC. If these auctions produce substantial discounts to face value, they should ring the alarm bells. In such a case, authorities should reconsider the policies that allow banks to pretend that toxic assets haven't fallen in value. In the meantime, it must be recognized that the curtailing of the PPIP program doesn't imply that the toxic assets problem has largely gone away; it has been merely swept under the carpet.

