Is the United States De-emphasizing its Bank Clean-Up Plan?

*Michael Mussa discusses the reasons why the Obama administration’s plan to remove toxic loans from bank balance sheets may turn out to be unnecessary.*


Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest, Michael Mussa, a senior fellow at the Peterson Institute, is here to talk about the latest actions by the federal government and in particular, the Treasury and the Fed, toward banks. Thanks for joining us, Mike.

Michael Mussa: My pleasure.

Steve Weisman: Mike, I want to ask you about the bank rescue, which you and I have discussed in this forum. There are news reports today, June 8, that a key part of the Treasury’s announced program, an elaborate mechanism to allow banks to sell off their so-called toxic assets, is not working or it’s been suspended. What is going on and why?

Michael Mussa: Well, it hasn’t really been launched yet. They’re in the process of designating the firms that would become the managers of these public-private investment trusts. But they haven’t even announced that yet and we’re not behind schedule very much in terms of what they were intending. But it looks now as if they’re deemphasizing the program, particularly the part of it that was supposed to be dealing with bank loans as opposed to securities, and that was going to be partially financed by the FDIC.

I think this is linked to the results of the stress tests, which were publicly released a month ago, and to the indications that a number of the larger banks that were the subject of the stress tests have been able to raise significant capital in private markets, suggesting that there isn’t really such a large need for a government-sponsored program to purchase assets off their balance sheets. I think, last time when we talked about it, I suggested that there might be a limited purpose for this program but the notion that it was a grand solution to the entire problem was a bit overdone.

Steve Weisman: What loans are we talking about that the banks would be selling off under this program that is being deemphasized? Credit card loans, commercial loans?

Michael Mussa: Yes, some credit card loans, some commercial loans, the loans that banks typically do hold on their balance sheet, as opposed to those things that they package into securities and then sell off to other purchasers. The securities are a separate aspect of it. There’s a difference in the accounting treatment. The loans are carried at their acquisition cost less a modest reserve; the securities are marked to market at the end of every accounting period. So there’s been less pressure on the valuation of the loans on the balance sheets than there has been on the securities.
Steve Weisman: So these loans, in other words, don’t have to be marked to market. But if they had been, they’d certainly be valued at less than what the banks are carrying on their books.

Michael Mussa: Probably so. I mean, one of the difficulties is that for many of these types of loans, there isn’t really a very active market. So asking what the price would be if we had to have a fire sale for the loans is not a particularly useful question to ask. For the securities, where there has been in the past at least a more active market, it’s a more reasonable question. And the difficulty has been that the market has dried up and so there’s not much in the way of effective pricing there either. But on the securities, they’re required to mark to market in accord with how the accountants treat them.

Steve Weisman: What is the role of the FDIC in what essentially is a Treasury program to unload these loans?

Michael Mussa: Well, the Treasury is organizing or helping to organize private partnerships where the partnerships would put in equity and the Treasury, out of the Troubled Asset Relief Program (TARP), would put in an equal amount of equity. But then additional funding, lending, would be provided by the Federal Reserve in the case of securities purchases and by the FDIC in the case of the loan purchases. So the suppliers of the equity, the Treasury and the private partnership, would provide 20 or 30 percent of the funding and then they would borrow the rest, either from the Federal Reserve for the securities component or the FDIC for the loan component.

Steve Weisman: Is the FDIC balking?

Michael Mussa: Well, it’s a little hard to say. I think what’s been said by the FDIC is that they find that there are not very many banks that are interested in participating in this program and selling off their loans. So if the banks aren’t interested in it, I mean why should they push it?

Steve Weisman: Why aren’t the banks interested if they’re so toxic?

Michael Mussa: I think that part of the answer is they’re not all that toxic and the banks probably find that they think that they can recover as much value by holding on to these assets until they are ultimately paid off for default as they could obtain if they sold them to one of these partnerships.

Steve Weisman: And it would not behoove the Treasury to push them to sell them against their better judgment, would it?

Michael Mussa: Probably not. Now, the Treasury has also been concerned that if the banks keep these assets on their balance sheet, that deters them from using the proceeds otherwise available to make additional new loans. I think that that concern has been overrated. I mean after all, the assets are going to need to be somewhere and if the private partnerships take them over, then that leaves the banks with more money to lend out but the private partnerships otherwise would have used their money for something else.

So it’s not necessarily clear that we really require, from the standpoint of the general supply of credit, to move these assets off the balance sheets of banks. In some individual cases, that may well be useful and that’s why I think there is some limited role that these
partnerships might still play that is positive. But the solution for many of the assets, even the ones that are so-called troubled, is simply to leave them where they are.

Steve Weisman: And of course that was, in a way, at the risk of oversimplifying, what you thought should happen in general, anyway.

Michael Mussa: Yes. For the bulk of the assets, it doesn’t seem to me that there’s a point in moving them from one balance sheet to another. If the government and the partnerships are going to pay too much, well, then there’s a loss potentially to the taxpayer and that’s not helpful.

Steve Weisman: Right.

Michael Mussa: On the other hand, the banks, you don’t want to force them to sell the assets at less than they really think they’re worth. So in many cases, I mean they made the loans and many of them are still performing. There’s a worry about whether they might default at a later date but there’s, in most cases, no reason why the banks should not continue themselves to hold these assets pending determination of whether they will pay off or not. There will be instances in which it will be useful for them to be able to liquefy some of it.

Steve Weisman: Does this tell us something about the other broad question of the securities? The packaged securities that are also toxic assets and the other half of this program that was supposed to address those.

Michael Mussa: Well, the securities of course have already been marked down because they’ve been marked to market. And as financial markets have recovered from the lows of late February or early March, probably the values of these assets have been coming up rather than down. And we may now be in the situation where at the end of the second quarter, when banks reevaluate their balance sheets, they’ll actually be writing up the values of some of these assets rather than writing them down. And why should they want to avoid that?

So I think that the recovery in financial markets has clearly affected the values of some of these assets. We know that because if we look at the value of junk bonds sold in the market or the value of some of these closed-in funds that hold things similar to bank loans, their values have recovered significantly from the lows of early this year. And banks will begin to reflect now some gains on the values of these assets that have been written down substantially in recent quarters.

Steve Weisman: I guess I was kind of ignorant. I thought the loans—I understood that the loans were not marked to market but I thought the securities packages were also not being marked to market. Is that uniformly true?

Michael Mussa: Well, the problem is marked to market is not a well-defined outcome. So there are so-called Category One assets where there is an active market all the time, no problem. There are other assets whose value can be quite easily inferred from assets that are very similar that are traded regularly in the markets. Then there are the so-called Category Three assets, which are the problem ones that we’ve been discussing. And there isn’t really an active market so somebody creates a model and there are a lot of question marks about what is the proper valuation of those assets.
Maybe there's something that's somewhat similar that's been traded in low volume someplace else and has a very low price, and the procedure used to be that you had to recognize that lowest price, most recent price, and that could be leading to some distortions. They've relaxed the accounting rules…

Steve Weisman: They've relaxed that, yes...

Michael Mussa: So that has changed the situation some. I think the main thing that has changed is that market prices have come up some.

Steve Weisman: And indeed, the markets have generally, as I said earlier, responded positively to the results of the stress tests. The banks, many of them, have been able to raise capital. Are you surprised that the stress tests—the much maligned, much derided, controversial stress test process—produced this result?

Michael Mussa: Not that surprised, actually. I mean you certainly couldn't have had a stress test where they said there's no problem anywhere. On the other hand, you certainly aren't going to have a result that is going to say virtually all of the banks are on the verge of collapse. We know from the officially reported results that come at the end of every quarter that the regulators were continually saying the banks have adequate capital as we've measured it by our standard measures. And the stress tests were supposed to update that and to ask what would happen in the event we had somewhat less-optimistic outcome for the economy but not a return of the Great Depression.

So if they were saying before the stress test, “they're adequately capitalized,” then it was reasonable to assume that under a somewhat more-stressed scenario, they would also reach the conclusion that most of the financial institutions were still substantially solvent, even if some of them needed to raise some additional capital as an additional margin of safety. And that was the conclusion that basically came out.

Steve Weisman: In the end, though, you felt it was a basically credible process?

Michael Mussa: Yes. And I think it gave an opportunity to kind of reach a period at the end, where the Treasury and the Fed could say “we've looked carefully at these institutions, we think that they're solid, we have good reason to believe that, and some of them need to raise some additional capital, but we're not going to be continually returning to this question of whether we need to nationalize additional institutions or not, unless the outcome for the economy actually turns out to be substantially worse than we now anticipate.”

So we can sort of put closure for a while to all these questions about whether the banks are going to be continuing in business, whether the government is going to be intervening in them much more actively. So I think it was useful to put a period and to say, “unless the economy deteriorates substantially more than is now anticipated, we believe the banking system is in reasonable condition, both to survive and also to undertake the lending that is necessary to support economic expansion.”

Steve Weisman: Mike, thank you. We’ll put a period now at the end of this interview. But come back and talk about this more. Thanks again.

Michael Mussa: Very good.