

Cleaning the Banking System's Toxic Waste Dumps

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Understanding the risks in the banking system is Chris Whalen's job. He is Managing Director of Institutional Risk Analytics, a Los Angeles-based provider of risk management tools and consulting services for auditors, regulators and financial professionals. He leads IRA's risk advisory practice and consults with global companies on a variety of financial and regulatory issues. Hailed by Nouriel Roubini as one of the leading independent analysts of the U.S. banking system, he nevertheless prefers not to be referred to as an expert. Chris volunteers as a regional director of the Washington DC chapter of Professional Risk Managers International Association. Media outlets, including The Globalist, CNBC, Bloomberg, and American Banker, have featured his commentary, as well as blogs such as The Big Picture and Seeking Alpha.

We spoke with Whalen on February 24, 2009.

Which banks, specifically, are in the most trouble? How long before they will be forced to raise more capital or before some other event forces the government to deal with their stability?

My ranking of the top four banks, in order of most to least worrisome, is Citigroup, the Bank of America, Wells Fargo, and J.P. Morgan.

J.P. Morgan's relatively stronger position is attributable to a critical decision [CEO] Jamie Dimon made four years ago, shortly after he came there from Bank One. He sold their residential mortgage backed (RMBS) portfolio to GMAC, GE Capital and a bunch of other players. This allowed them to dodge the bullet as the CDO markets collapsed and to avoid the structured finance exposure that essentially dooms the other big banks, including Citigroup, UBS and Merrill Lynch, which the Bank of America was forced to absorb to save the primary dealer. Even though J.P. Morgan has bought itself some time, they still may not outrun the macro economy tsunami.

Citigroup, on the other hand, was already an outlier in terms of its credit loss rate before the onset of the crisis. Now its structured exposure sits on top of the thinnest tangible capital in the industry, even if they convert



the preferred as widely expected. As the credit crisis deepens, the loss rates out of Citigroup will be so high that its off-balance sheet losses may be greater than those on its balance sheet. This is the legacy that Sandy Weill and Robert Rubin have left for the Citigroup shareholders.

Turning to Bank of America, as I said, Ken Lewis seemingly was bullied into saving Merrill Lynch, and that acquisition now may cripple the bank. Bank of America started 2008 as the most stable large bank holding company, and it is now just behind Citigroup as the second weakest bank, in my view.

Well Fargo's status is less clear. The wisdom in the lending origination channel is that slamming Wells and Wachovia together was a marriage of two weak players. If this is true, then Wells faces serious problems, especially if the economy remains weaker than official projections. One observer told me that success in terms of Wells absorbing Wachovia requires a Q3 09 economic bounce, but this seems unlikely.

When Jamie Dimon bought Washington Mutual, he bought the bank after it had been restructured and paid only a few cents on the dollar for its assets, allowing him to aggressively clean up its balance sheet. J.P. Morgan is now in the middle of its peer group, with an efficiency rating of 50%, versus 65% for Citigroup. [Ed. Note: The efficiency rating measures the cost of acquiring a new dollar of revenue. An efficiency rating of 50% implies a cost of 50 cents to generate a dollar of new business.]

Interestingly, Dimon, in addition to selling the RMBS business, made an earlier move that illustrates his management approach to cost cutting and business model choices. Immediately after taking charge at Banc One, he closed Wingspan Bank, the loss-leading Internet banking effort. He has demonstrated a different operating mentality from his peers, and that has kept his firm out of the worst troubles in the industry — at least so far.

In terms of the industry as a whole, much of the cancer is at the top. Of the \$1 trillion in banking industry write-offs we forecast for this year, two-thirds will occur in these top four banks.

For financial advisors, the important implication is that the bottom two-thirds of the industry may be boring, but it is safe and stable.

At the end of the third quarter of last year, two-thirds of U.S. banks were rated A or A-plus. By the end of this year, that percentage will drop to about half of all banks. The industry will continue to see losses, but the major parts of the banking system are okay.



Is “nationalization” the correct characterization of the solution the government is undertaking?

I would characterize the solution as “restructuring,” and it is happening now with Citigroup. You must differentiate the political narrative from the operating reality. Citigroup is operating under open bank assistance and sharing losses with the government. It is halfway through the process of resolving its situation. Open bank assistance will continue and common shareholders will suffer more dilution. Ultimately, conservatorship is the right legal structure, but the Obama administration is reluctant to put bond holders to the sword

Citigroup’s depositors — both foreign and domestic — will have their accounts protected 100% on the dollar. That will take half of Citigroup’s liabilities off the table. The other half is the bond holders. With Citigroup’s liabilities at two or three times the level that can be supported by its Tier 1 capital, either the bond holders must take a haircut or the government must inject more capital.

Last year, Citigroup had \$106 billion in revenues, \$62 billion in sales, general and administrative costs (SG & A,) and \$33 billion in loan loss provisions. Its revenue will fall and may be as low as \$90 billion this year, so it has a cost structure far out of line with its peers and no more revenue to bolster loss provisions.

Citigroup has run out of runway.

How bad are the troubles in the European banking system?

If you think the US banking industry is bad, things are much worse in Europe. The European banking industry is a wasteland. Financial institutions will take enormous losses — in the trillions of dollars — due primarily to exposure to structured finance.

In fact, Europe doesn’t even have a de novo banking system. More new banks were started in the state of Texas last year than in the entire EU.

Financial advisors should be very careful of their exposure to the European banking system. But if we employ some “tough love,” we can regenerate what is left of our banking system here in the US.



What steps would you like to see to instill stability in the banking system?

[FDIC Chairperson] Sheila Bair and [Treasury Secretary] Tim Geithner should move to resolve Citigroup. Citigroup has already hypothecated its assets to the government via the TARP and the loss-sharing agreement, so the process can be managed.

These officials can do what they want if they have the political support. The only issue is whether to wipe out the equity and force the bond holders to take a haircut, or continue to subsidize the bond holders by adding more equity. Either way, this is “tough love,” and that is what we are doing at the present time.

On the other side of the restructuring process, there are banks and private entities that want to buy assets but will not put money into an existing holding company. Remember the example of J.P. Morgan buying WaMu. That is the right way to buy a troubled bank — cleaned and restructured.

Once you get past the four top banks there are a host of banks that are healthy and ready to buy branches and other assets. These banks include names like U.S. Bancorp, WestAmerica Bancorp, and Fulton Bank.

The key is to act quickly, or else the situation will deteriorate and market participants will lose confidence. The markets and US consumers want finality. They want an adult to walk in the room and say “here is what we are going to do.”

Geithner had not thought through the implications of the bank bailout plan he proposed last week. He did not realize that Fannie Mae and Freddie Mac would have to change their charter to buy some of the assets he had proposed. We are still making things up as we go along.

In the 1990s, Sweden had a banking crisis, which it resolved by nationalizing and then re-privatizing its banks. How does our situation relate to the Swedish experience?

I don't think this is a fair comparison. The solution is to follow the American model, based on the RTC and RFC approach, not any European models. The only thing the Europeans know how to do is destroy value.

The Obama Administration wants to help homeowners, but they refuse to address the issue of toxic assets. The lesson of securitization is that we



can't have an agent lend money and then sell loans to an investor. The incentives get lost. This is the key structural issue.

How much impact would mark-to-market have? Or creating a bad bank to buy toxic assets? Could “restructuring” be avoided?

The losses are there and they are real. Mark-to-market was a reaction to opacity in order to get better disclosure. But it didn't help with illiquid assets. Credit default swaps are not good pricing for such risks; there really is no reliable, visible market for credit default exposure on things like corporate bonds and mortgage backed securities, and thus no way to price them.

We have to live with mark-to-market. Another change in rules would be too destabilizing.

In time, I would like to see mark-to-market modified to impose a time test on swings in valuation. This would avoid short-term price fluctuations and get to something that more closely approximates value. Volatility is too high and imposes unrealistic capital requirements on banks. Remember, the Chicago School is wrong. Price does not equal value. That is the lesson we learned from events like the collapse of AIG.

Sarbanes-Oxley regulation was the beginning of the mark-to-market problem. Banks started marking down assets long before the bubble burst.

The problem with mark-to-market accounting is simple – it was conceived by accountants. If business people had looked at the problem, instead of letting the accountants define the solution, an entirely different regimen would have emerged.

Requiring disclosure of asset valuations is commendable, but this should not affect capital requirements in the way it does now.

No matter what rule is adopted, bankers and traders will game it.

Is restructuring a lot easier now than in six months?

The market will take events into its own hands. Citigroup's situation must be resolved by the end of the first quarter. If it is not, the market will drive events. Inaction is not an option.



We must act now - when we are in control - not later, when we would be in reactive mode.

What is the political resistance to the current steps being taken by the administration?

The bond holders of the big banks are highly politically organized, starting with foreign governments, central banks, and managers such as PIMCO. With backing from foreign, supranational, and domestic stakeholders, the bond holders are very powerful.

On the other hand, the Treasury has a limited ability to provide cash to subsidize operating losses.

Can “restructuring” fail? What are the biggest risks?

It is what is: Selling assets for pennies on dollar gets rid of the problem. Selling branches to stronger players makes the industry and the economy healthier. The driver in terms of timing the resolution must be to manage the cash flow deficit of the troubled entities.

The government should get good prices for Citigroup’s off-shore assets. Citigroup will come out the other side a lot smaller. It will have a much smaller capital markets business, with no off-shore operations, and will look a lot like the Bank of America.

What do you expect the banking industry to look like in two years?

The concentration of assets in the industry will be evenly distributed. Citigroup and Bank of America will be restructured and will emerge a half or a third of their current size.

Likewise, Wells will sell the Wachovia assets like its branches in the northeast. Depending on the capital that must be to put in to Wells/Wachovia, it may get broken up. It is telling that Wells is not consolidating Wachovia with its existing operating units.

The next 10 banks — starting with U.S. Bancorp — will be larger. That will be the shape of the industry.

Instead of one-third or forty percent of industry assets in the top 10 banks, these assets will be in the top 20 or 30 banks.



Reduced concentration means a healthier system, with less overall risk. The Congress should take steps to ensure that depositories are not allowed to grow to the size of Citigroup, the Bank of America and J.P. Morgan. There are no economies of scale in true banking, but, thankfully, even these large derivatives casinos are not really comparable to community banks. That is the key point to make about Citigroup, UBS, Lehman, and Merrill: all were toxic waste dumps of illiquid securities and derivatives.

Would you buy any bank stocks or debt now?

I am almost ready to tell people to buy smaller bank stocks, but I am holding my breath to see if the stimulus works and where loss rates peak. Meanwhile, I am short Treasury bonds. Pick strong banks and watch them going into Q2.

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