

Roubini: Bank Write-offs are at the Halfway Point

Robert Huebscher

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Nouriel Roubini

US banks and brokerage firms have written-off approximately \$572 billion in loan losses since the onset of the credit crisis. But at least another \$500 billion will be written-off over the next two years, as housing prices plummet and unemployment rises, according to a report issued by Nouriel Roubini and Elisa Parisi-Capone, colleagues at the [RGE Monitor](#). Roubini is a Professor of Economics at the NYU Stern School of Business, and has gained wide-spread notoriety for his highly prescient predictions, beginning in 2006, of the current crisis.

“US banks and brokerage firms are about one-half way through the process of writing off bad loans,” said Parisi-Capone in an interview on January 26.

On a global basis, total loan losses on securities originated in the US will reach \$3.6 trillion, consisting of \$1.6 trillion in write-offs and \$2.0 trillion in mark-to-market losses, based on market prices as of December 2008. US banks and broker dealers will incur about half of these losses, or approximately \$1.0 to \$1.1 trillion in write-offs and \$600-\$700 billion in securities writedowns. The \$1.0-\$1.1 trillion estimate includes the \$572 billion already written-off.

Roubini and Parisi-Capone’s estimates rely on two key assumptions: housing prices will decline by an additional 20% (implying a peak-to-trough decline of 38%-40%) and unemployment will peak at 9%. They also assume GDP will contract by 5% in the current recession. But their model is most sensitive to housing prices, and Parisi-Capone explained that the relationship is not linear. As housing prices decline, delinquencies and defaults accelerate at a faster rate. If housing prices decline by more than the 20% they estimate, the consequences for loan write-offs will be severe.

Housing prices will bottom in 2010, according to Roubini and Parisi-Capone. They forecast that the remaining \$500 billion will be written off by banks and brokerage firms in 2009 and 2010.

Mark-to-market losses are harder to quantify than loan write-offs, for two reasons. First, as Roubini and Parisi-Capone note, they have been offset by “increased activity in the government-sponsored sectors” (i.e., government purchases of mortgage backed securities have, to some degree, artificially



inflated the prices of those securities). More importantly, mark-to-market losses may be overstated because illiquidity in these markets has driven down prices. But, Roubini and Parisi-Capone say even if this illiquidity overstatement resulted in a 20% undervaluation, total global exposure would still be extreme - \$3.2 trillion instead of \$3.6 trillion.

Roubini and Parisi-Capone provide the following breakdown for loan write-offs:

Category	Amount Outstanding	Current Losses	RGE Estimated Total Losses	US Exposure
Sub-prime	300	57	150	120
Alt-A	600	64	150	105
Prime	3,800	105	266	95
Commercial Real Estate	2,400	142	408	285
Consumer Loans	1,400	102	238	180
Corporate Loans	3,700	96	370	295
Leveraged Loans	170	6	51	35
Total				

All numbers are in \$ billions.

They provide the following breakdown for mark-to-market (MTM) losses:

Category	Amount Outstanding	RGE Est. MTM Losses as of 12/08	US Share of Estimated Losses
ABS	1,100	550	171
ABS CDO	400	380	125
Prime MBS	3,800	114	22
CMBS	940	282	93
Consumer ABS	650	130	43
High-grade Corporate Debt	3,800	190	70
High-yield Corporate Debt	600	150	57
CLOs	350	123	48
Total			

All numbers are in \$ billions. Estimates are from RGE.

Roubini and Parisi-Capone's key concern relates to the solvency of the US banking system. Prior to the onset of the credit crisis, the capitalization of the US



banking system was \$1.4 trillion, which corresponded to the 8% capital ratio required by Basel II. Expected loan write-offs are \$1.1 trillion and mark-to-market losses are \$600-\$700 billion, together totaling \$1.8 trillion and creating a capital shortfall of approximately \$400 billion. TARP 1 injected \$230 billion into the banking system, with private investors and sovereign wealth funds providing another \$200 billion in capital, but that still leaves the banking system “borderline insolvent,” according to Roubini and Parisi-Capone.

An additional \$1.4 trillion of capital is needed to restore the banking system to its pre-crisis capitalization levels, and more if the 8% ratio is deemed insufficient. Some of this will come from TARP 2 (which has \$350 billion in funds yet-to-be allocated), but future programs (e.g., TARP 3 and TARP 4) will be necessary to provide an additional \$1+ trillion.

Moreover, this analysis does not include insurance companies, finance companies, and other institutions (e.g., GMAC and GE Capital).

“The US banking system is borderline insolvent in the aggregate and it will take a huge amount of public financial resources and complex and time-consuming work-out of insolvent institutions to restore its financial health and allow it to lend again in ways that support sustained economic growth,” say Roubini and Parisi-Capone.

A full copy of Roubini and Parisi-Capone’s report is available to paid subscribers of the RGE Monitor.

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