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# Wary Banks Hobble Toxic-Asset Plan

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*Timothy Geithner*

The government's plan to enable banks to dump troubled assets is facing troubles of its own. Markets initially rallied when Treasury Secretary Timothy Geithner announced in March a two-pronged plan to offer favorable government financing to entice investors to buy bad loans and toxic securities from banks.

But that initiative -- called the Public-Private Investment Program, or PPIP -- has lost momentum. Big banks worried about having to sell at fire-sale prices while small banks feared they would be shut out. Potential buyers balked at the risk of doing business with the government, concerned that politicians might demonize them for making big profits. The program's problems threaten to stymie efforts by struggling smaller banks, in particular, to clean up their balance sheets. That in turn could hinder efforts to revive the nation's economy.

A look at why the program has stumbled underscores how difficult it has been to solve one of the economy's biggest problems: Mountains of bad debt sitting on the books of the nation's banks. As those loans and securities lose value, they are saddling the banks with losses and constricting their ability to lend.

U.S. officials and investors are playing down expectations for the plan -- originally billed as a \$1 trillion endeavor. Some federal officials say the banking environment has improved since the program was unveiled. They assert that because a dozen or so big banks recently succeeded in raising capital, they are under less pressure to sell bad assets.

Early this month, the Federal Deposit Insurance Corp. essentially shelved one arm of PPIP -- the government-financed buying of bad bank loans. Mr. Geithner recently said the other part -- to facilitate the buying from banks of troubled securities, many backed by real-estate loans -- could be scaled back because investors are "reluctant to participate." This week, the government is expected to name investment firms to manage this securities-buying portion. "The fits and starts on all this stuff has added to the uncertainty that makes [investors] stay on the sidelines," says Trabo Reed, the deputy banking superintendent in Alabama, where many small and midsize banks are looking for cash infusions from investors.

## **Bailout Tracker**

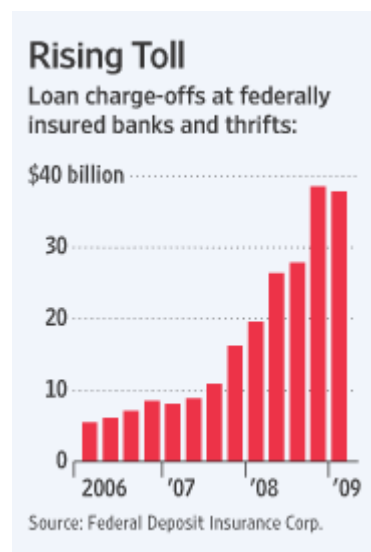
Lee Sachs, counselor to the Treasury secretary, says the department remains committed to the program and has received more than 100 applications from would-be investment managers. "One of the goals of the PPIP program has been to help create liquidity in frozen markets," he says. "Some banks will sell assets. Even those that do not will benefit from the greater ability to value the assets they hold."

The slimmed-down program will focus not on bad loans, but on toxic securities, which are a problem for a relatively small fraction of the nation's banks. That is bad news for hundreds of smaller banks burdened with growing piles of defaulted loans. These banks are less able to tap capital markets than their larger rivals, so they have been eager for U.S. help unloading loans as a way to bolster their capital cushions. Many of them can face big problems if just one or two large loans go bad. Seventy banks, most of them community institutions, have failed since the start of last year. Analysts are bracing for hundreds of lenders to collapse in the next few years. Because these lenders often play key roles supporting their local economies, taken together, they are important to the financial system and to a U.S. economic recovery, says Kenneth Segal, senior vice president at Howe Barnes Hoefler & Arnett Inc., an advisory firm for small and midsize lenders.

During the last banking crisis, nearly two decades ago, the government established the Resolution Trust Corp. to sell off the bad loans and securities of banks that had failed. Many experts credit the RTC with helping defuse that crisis.

This time around, efforts to rid banks of soured assets have sputtered repeatedly. In late 2007, federal officials helped cobble together a plan for a bank-financed fund to buy securities held by bank investment funds, but the effort was aborted. In 2008, the Bush administration established a \$700 billion program to buy banks' soured assets. Partly because of the complexity of valuing those assets, the U.S. abandoned that plan, instead opting to directly pump taxpayer money into banks.

Scott Romanoff, a Goldman Sachs Group Inc. managing director, has referred to the current effort, PPIP, as "the greatest program that never occurred," because it "created confidence in the markets so banks can raise equity capital."



In recent weeks, markets have lost some vigor amid renewed concerns about the economy. That could make it more difficult for big banks to raise additional capital. Banks also could face further losses as bad assets decline more in value.

On March 23, when Mr. Geithner unveiled PPIP, the Dow Jones Industrial Average surged nearly 500 points, or 7%, its biggest gain since October, on hopes that the program would nurse the banking industry back to health.

Many bank executives were skeptical about whether the program could succeed. Even before it was announced, some had grumbled that federal officials weren't consulting them, and instead were crafting the initiative with input from would-be investors. Some banking executives say they warned that they would be loath to sell at the kind of prices investors were likely to demand.

Executives at [Citigroup Inc.](#) shared those concerns, according to people familiar with the matter. While the New York bank was sitting on at least \$300 billion of risky loans and securities, selling them at discounted prices would require painful hits to its already thin capital ratios, these people say.

Some Citigroup executives had a different idea: Maybe they could turn a profit by bidding on their own toxic assets at discounted prices, using government financing, according to the people familiar with the talks. Other big banks also talked about setting up distressed-asset units to snap up troubled loans and securities, including from their parent companies, with taxpayer financing.

FDIC Chairman Sheila Bair later publicly shot down the idea. Citigroup declined to comment. Meanwhile, many small-town bankers hoped the program would help them unload the bad assets -- generally loans to finance commercial real-estate projects -- that were hurting their balance sheets. Some potential buyers had surfaced before PPIP was announced, but they were offering such low prices that few banks could afford to sell the loans without severely denting their capital cushions.

The hope was that PPIP would help narrow the gap between buyers and sellers. Investors would be able to bid more because the government would offer buyers little-money-down financing, along with some downside protection.

"We have illiquid assets," says Patrick Patrick, chief executive of Towne Bancorp of Mesa, Ariz. "It would be helpful to have a vehicle where you could sell them at market and be able to restructure our balance sheet."

Like many small banks, Towne Bancorp has been hurt by a handful of loans to finance real-estate projects that went belly up. In the first quarter, the bank said two souring commercial real-estate loans caused its portfolio of loans at least 90 days past due to swell by 52%. Such loans represent more than 22% of Towne Bancorp's \$143 million in assets. The company has been trying for months to sell 19 pieces of real estate -- including undeveloped land and a warehouse -- that it seized when loans went into default.

When PPIP was announced, big-name investors were intent on figuring out how to profit from it. Raymond Dalio of giant hedge-fund firm Bridgewater Associates, which oversees \$72 billion in assets, initially expressed interest in participating. But within days, he was blasting it, saying buyers and sellers would have difficulty agreeing on pricing and fund managers that profited would be exposed to criticism from politicians. The way PPIP is set up "makes us not want to participate and it makes us question the breadth of interest that we will see in the program," he wrote to clients.

Lawyers for hedge funds and private-equity investors warned clients about the risks of doing business with the government. The industry was unnerved by the restrictions placed on banks participating in another federal bailout program, the Troubled Asset Relief Program. Fund managers were also bothered by President Barack Obama's criticism of the hedge funds holding Chrysler LLC debt who had refused the government's buyout offers.

In conference calls with bankers and investors, FDIC officials emphasized that PPIP was critically important to cleanse banks of their bad assets. "I think you know the stakes are very high with this," Ms. Bair, the FDIC chairman, said during a March 26 call, according to a transcript. "We need this program to work."

Ms. Bair and her deputies encountered skepticism. In an April 9 conference call with the FDIC, Mark Wolf of TRI Investments LLC, described his Carlsbad, Calif., firm as a potential PPIP bidder. "Unless you've got a process that either forces banks to sell or does a better job of

encouraging them to sell, we're just going to see banks sitting back and dribbling these things out through an eyedropper over the course of time," he said.



FDIC Chairman Sheila Bair and her deputies encountered skepticism about the plan during conference calls with bankers and investors.

Some bankers were hesitant. "If these loans are bought at a discount, we create a hole in capital," Lou Akers, executive vice president of Adams National Bank in Washington, told FDIC officials on the March 26 call. He suggested that regulators consider changing the way they calculate banks' capital in order to cushion the blow.

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To participate in PPIP, local lenders were told, they would have to pool their loans with other banks. The process, which the FDIC said it would facilitate, was designed to simplify the bidding process for government officials and prospective investors. The agency didn't want thousands of banks put their loan portfolios on the block separately.

But the FDIC planned to require participating banks to kick in a minimum amount of assets, and some small-town bankers worried they wouldn't have enough to qualify.

Too high a minimum "will virtually eliminate all community banks from being able to participate in this program," wrote Julian L. Fruhling, president of Legacy Bank in Scottsdale, Ariz., in a letter to the FDIC.

Still, some investment firms that were hoping to help manage the government's program were optimistic. Laurence Fink, chief executive of BlackRock Inc., said in mid-April during a trip to Japan that if his firm is selected as a manager, it was ready to raise \$5 billion to \$7 billion to buy securities through PPIP. He said he hoped to raise money from individual investors in Japan and the U.S., and that potential returns could be as high as 20%.

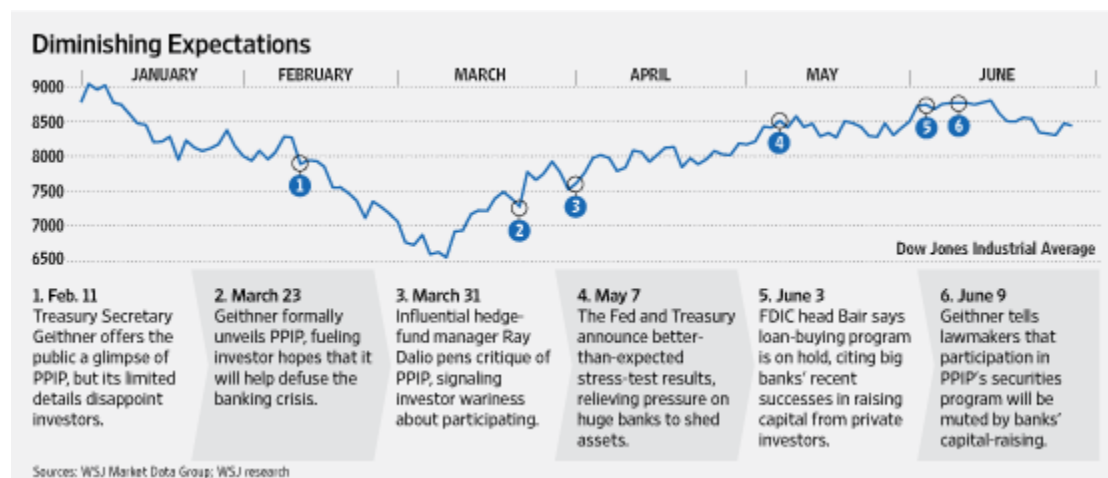
The FDIC and other regulatory agencies were planning to use their "stress tests" of the nation's top 19 banks to push them to sell assets via PPIP, according to people familiar with the matter. But in the weeks before the stress-test results were announced in May, market sentiment began to improve. A number of banks succeeded in raising capital by selling new shares to the public. Once the stress tests were wrapped up in May, even more banks sold shares -- a total of roughly \$65 billion within a month. The capital-raising removed regulators' leverage to encourage participation in PPIP, according to government officials.

Around the same time, BlackRock reduced its goal for the size of its potential PPIP investment fund to about \$1 billion, say people familiar with the matter. Earlier this month, the FDIC formally postponed the loan-buying portion of PPIP, called the Legacy Loan Program. "Banks have been able to raise capital without having to sell bad assets through the LLP, which reflects renewed investor confidence in our banking system," Ms. Bair said.

Next month, the FDIC intends to use PPIP for a far narrower purpose: to auction loans the agency has seized from failed banks. Eventually, it hopes to resuscitate the loan-buying program so that smaller banks can benefit from it.

But that could be tricky. The U.S. initially justified PPIP by invoking its "systemic risk" powers, which enable regulators to step in when the financial system is at risk. Regulators have debated whether such a justification would remain if the program were geared toward smaller banks. FDIC officials doubt they will muster the necessary consensus among regulators to invoke the special powers and keep the loan program alive, according to a person familiar with the matter. Many banking experts contend that the financial system won't fully stabilize until banks get rid of their bad assets.

Mr. Segal, the bank adviser, complains that federal officials have cited recent capital raising by big banks as evidence that "the system is OK." That may be true "for the top 15 or 20 banks," he says. "But for everybody else, there really needs to be more attention paid."



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