WHY NOT AN EVEN TRILLION

by Steve Brown

With President Bush's dire warning last night, he made the statement that the Rescue Plan is "big enough to solve a serious problem." We are not so sure, but then again, we don't have the foggiest notion. However, to educate ourselves, we wanted to pull some numbers and conduct a high-level sanity check.

To start, we looked at the Fed's flow of funds data and found that the amount of outstanding residential mortgage debt (less agriculture) is $11.2T. On top of that, we have $2.5T in CRE related debt that isn't included in the above number. So now we know the potential size of the problem is $13.6T of real estate related issues. We are really hoping we don't have to do another column regarding the collapsing of C&I and consumer debt, so let's just focus on the real estate problem right now. Let's look at who owns this debt.

From the GSE's balance sheets, we can see that they have put in their portfolio or guarantee $7.9T of debt. If you deduct the debt that the GSE's have guaranteed, but hold in portfolio, the net number is $7.1T. Since the Gov't already essentially controls these assets, we can deduct that from the potential of assets that would be used by the Trouble Asset Rescue Plan (we finally have coalesced around the acronym, "TARP"). The difference is at least $6.5T of mortgage related assets that could run into trouble. We say at least, becuase it is difficult to calculate the amount of credit default, index or other credit derivative exposure, but an estimate would be at least another $1T. Since it is unclear at this time whether the TARP facility will be taking synthetic exposure, we will leave it out of the equation for now. To do a common sense check, commercial paper conduits have $2T of this debt outstanding according to issuance reports (i.e. league tables), commercial banks/thrifts/credit unions hold about $6.8T (including some of the conduit paper that we didn't double count), so we know we are in the right ballpark, give or take a couple trillion of overlap and miscellaneous holdings.

So, if we work off the $6.5T number and apply our expected loss statistics from our loan pricing model weighted for residential, we get a troubled asset amount of a little over $200B. This figure would be something akin to the "fire sale" value that Chair Bernanke talked about yesterday - defaulted assets priced near their equity value (current property price - debt and transaction costs).

Another way to look at this is to take the $6.5T number and multiply that not by the expected loss, but by the probability of default, which produces a number closer to $660B. This is closer to the "hold-to-maturity" value and assumes that banks would sell all assets it believes were going to have payment trouble in the future (or currently have). Of course, banks will be overly cautious and will most likely sell a higher amount of assets to be on the safe side. Thus, we can expect that demand for credit into the TARP facility may be double those previously mentioned $200B and $660B numbers as a rough estimate.

Another way to triangulate the $700B facility amount is to look at actual asset pricing in the market for non-guaranteed mortgage product. Here, we are seeing prices for distressed assets on the order of $0.20 on the dollar and prices for performing assets at $0.80 on the dollar. If you assume that, because of adverse selection, 75% of the assets sold into the facility are either non-performing or will turn non-performing quickly, then we can guess that the fair market price for the average $6.5T in assets, would equate to $0.35 on the dollar. Multiply this average price by the $6.5T and we get $2.2T of demand. Since the industry has just over $2.7T in capital, you can assume that the write-offs will be closer to 20% of the capital number or roughly $676B. That is, while financial institutions have more bad assets on their books, they will only sell $676B due to collateral constraints.

We are sure we missed a couple of things here, but our back-of-the-napkin analysis of the nation's collective balance sheet indicates that $700B is reasonably sized, but an awfully large number in comparison to the economy. Yes, the number may be way off, but what is a trillion between friends.

BANK NEWS

M&A

Hampton Roads Bankshares Inc. ($845.5mm, VA) has entered a deal to acquire Gateway Financial ($2.13B, VA) for $101.3mm or 0.72x book value. Gateway took a $40.4mm write-down related to FNMA/FHLMC preferred stock shares. The combined the institution will have 64 branches.

Needed

The ABA will launch an ad campaign today that helps the public understand the difference between FDIC-insured banks from the generic a "bank" (i.e., Wall Street institution) that everyone has been using. The material is available to ABA members to run locally as well.

Small Lenders

Fannie Mae has raised standards for loan sellers and servicers in an attempt to increase transparency. Included in these changes are increased net worth and capital ratio minimums.

Electronic Payments

Experts predict check volumes will fall to less than 18B transactions by 2009; however it is expected that businesses will continue to make up 60% of the volume.