

Executive Summary*

In the fall of 2008, the American economy was facing a crisis stemming from steep losses in the financial sector, and frozen credit markets. Then-Secretary of the Treasury Henry Paulson and Federal Reserve Board Chairman Ben Bernanke argued that a program of unprecedented scope was necessary to remove hundreds of billions of dollars in so-called toxic assets from banks' balance sheets in order to restore the flow of credit.

By the time the law creating the Troubled Asset Relief Program (TARP) was signed only a few weeks later, however, the Secretary had decided, due to a rapid deterioration in conditions, to use another, more direct, strategy permitted under TARP to rescue the financial system, by providing immediate capital infusions to banks to offset the impact of troubled assets. Now, ten months after its creation, TARP has not yet been used to purchase troubled assets from banks, although the capital infusions have provided breathing space for banks to write-down many of these assets and to build loss reserves against future write-downs and losses. This report discusses the implications of the retention of billions of dollars of troubled assets on bank balance sheets.

In the run-up to the financial crisis, banks and other lenders made millions of loans to homeowners across America, expecting that their money would eventually be paid back. It is now clear that many of these loans will never be repaid.

In some cases, financial institutions packaged these mortgage loans together and sold pieces of them into the market place as mortgage-backed securities. In other cases they held the mortgages as "whole loans" on their own books. In either case, these mortgages, and the securities based on them, are now said to be "troubled assets." They are no longer expected to be paid off in full, and they are very difficult to sell. There is no doubt that the banks holding these assets expect substantial losses, but the scale of those losses is far from clear.

As just noted, Treasury's choice to pursue direct capital purchases resulted in a notable stabilization of the financial system, and it allowed the write-down of billions of dollars of troubled assets and reserve building. But, it is likely that an overwhelming portion of the troubled assets from last October remain on bank balance sheets today.

If the troubled assets held by banks prove to be worth less than their balance sheets currently indicate, the banks may be required to raise more capital. If the losses are severe enough, some financial institutions may be forced to cease operations. This means that the future performance of the economy and the performance of the underlying loans, as well as the method of valuation of the assets, are critical to the continued operation of the banks.

*The Panel adopted this report with a 4-1 vote on August 10, 2009. Rep. Jeb Hensarling voted against the report. Additional views are available in Section Two of this report.

For many years, banks were required to mark their assets to market, meaning they listed the value for many assets based on what those assets would fetch in the marketplace. In response to the crisis, banks have been allowed greater flexibility in the way they value these assets. In most cases we would expect the new rules to have permitted banks to value assets at a higher level than before. So long as they do not sell or write-down those assets, they are not forced to recognize losses on them.

The uncertainty created by the financial crisis, including the uncertainty attributable to the troubled assets on bank balance sheets, caused banks to protect themselves by building up their capital reserves, including devoting TARP assistance to that end. One byproduct of devoting capital to absorbing losses was a reduction in funds for lending and a hesitation to lend even to borrowers who were formerly regarded as credit-worthy.

The recently conducted stress tests weighed the ability of the nation's 19 largest bank holding companies' to weather further losses from the troubled assets and assessed how much additional capital would be needed. However, the adequacy of the stress tests and the resulting adequacy of the capital buffer required for future financial stability depend heavily on the economic assumptions used in the tests. As more banks exit the TARP program, reliance on stress-testing for the economic stability of the banking system increases. The Panel's June report evaluated the adequacy of the stress tests.

Treasury's program to remove troubled assets from banks' balance sheets is the Public Private Investment Program (PPIP). It has two parts, a troubled securities initiative, administered by Treasury, and a troubled loans initiative, administered by the Federal Deposit Insurance Corporation (FDIC). Treasury is now moving forward with the troubled securities program. The FDIC has postponed the troubled loans program, stating that the banks' recently demonstrated ability to access the capital markets has made a program to deal with troubled whole loans unnecessary at this time. (The FDIC is conducting a pilot program for the sale of the loan portfolios of failed banks.) Whether the PPIP will jump start the market for troubled securities remains to be seen. It is also unclear whether the change in accounting rules that permit banks to carry assets at higher valuations will inhibit banks' willingness to sell. Similarly, it is unclear whether wariness of political risks will inhibit the willingness of potential buyers to purchase these assets.

If the economy worsens, especially if unemployment remains elevated or if the commercial real estate market collapses, then defaults will rise and the troubled assets will continue to deteriorate in value. Banks will incur further losses on their troubled assets. The financial system will remain vulnerable to the crisis conditions that TARP was meant to fix.

The problem of troubled assets is especially serious for the balance sheets of small banks. Small banks' troubled assets are generally whole loans, but Treasury's main program for removing troubled assets from banks' balance sheets, the PPIP will at present address only troubled mortgage securities and not whole loans. The problem is

compounded by the fact that banks smaller than those subjected to stress tests also hold greater concentrations of commercial real estate loans, which pose a potential threat of high defaults. Moreover, small banks have more difficulty accessing the capital markets than larger banks. Despite these difficulties, the adequacy of small banks' capital buffers has not been evaluated under the stress tests.

Given the ongoing uncertainty, vigilance is essential. If conditions exceed those in the worst case scenario of the recent stress tests, then stress-testing of the nation's largest banks should be repeated to evaluate what would happen if troubled assets suffered additional losses. Supervisors should continue their increased monitoring of problem banks, and banks too weak to survive write-downs should be required to raise more capital. If PPIP participation proves insufficient, Treasury may want to consider adapting the program to make it more robust or shifting to a different strategy to remove troubled assets from the banks' book. Treasury should also pay special attention to the risks posed by commercial real estate loans.

Part of the financial crisis was triggered by uncertainty about the value of banks' loan and securities portfolios. Changing accounting standards helped the banks temporarily by allowing them greater leeway in describing their assets, but it did not change the underlying problem. In order to advance a full recovery in the economy, there must be greater transparency, accountability, and clarity, from both the government and banks, about the scope of the troubled asset problem. Treasury and relevant government agencies should work together to move financial institutions toward sufficient disclosure of the terms and volume of troubled assets on institutions' books so that markets can function more effectively. Finally, as noted above, Treasury must keep in mind the particular challenges facing small banks.

This crisis was years in the making, and it won't be resolved overnight. But we are now ten months into TARP, and troubled assets remain a substantial danger to the financial system. Treasury has taken aggressive action to stabilize the banks, and the steps it has taken to address the problem of troubled assets, including capital infusions, stress-testing, continued monitoring of financial institutions' capital, and PPIP, have provided substantial protections against a repeat of 2008. These steps have also allowed the banks to take significant losses while building reserves. Nonetheless, financial stability remains at risk if the underlying problem of troubled assets remains unresolved.