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Dr. Michael Heise, Dr. Arne Holzhausen

The IMF, toxic assets and the taxpayer

Allianz

AUTHORS:

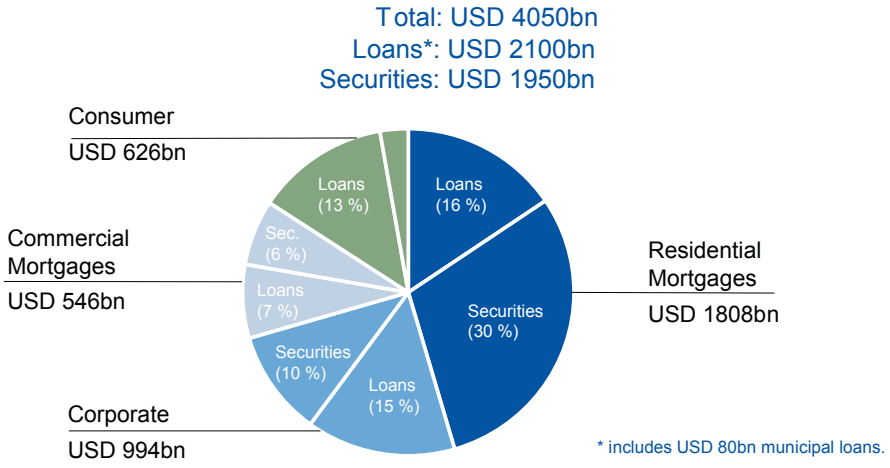
DR. MICHAEL HEISE
Tel.: +49.89.38 00-16143
michael.heise@allianz.com

DR. ARNE HOLZHAUSEN
Tel.: +49.89.38 00-17947
arne.holzhausen@allianz.com

THE IMF, TOXIC ASSETS AND THE TAXPAYER

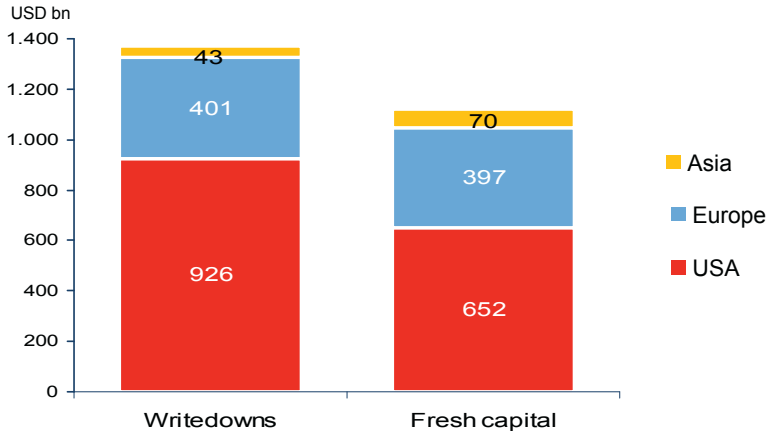
Dreaded toxic assets: the general perception is that a lot more is still lurking out there. According to the IMF and its latest "Global Financial Stability Report", the bill for the world's financial sector has now swollen to the enormous figure of USD 4,100bn; banks have to shoulder some USD 2,800bn. Although financial firms around the world have already recognized more than USD 1,300bn of losses (USD 950bn by banks), the "reality-gap" has in fact risen. So, with its new estimate the IMF did nothing less than remove the light at the end of the tunnel for banks. The figures sit oddly with the recent stabilization of the financial sector. However, the markets, jaded by an overflow of bad news in the past, seemed to decide simply not to listen and continued with the rally of bank stocks.

Financial crisis loss estimates by the IMF



Source: Global Financial Stability Report, April 2009.

Global writedowns and capital raised by financial institutions



Source: Bloomberg.

Could it be that the loss calculations are themselves pro-cyclical? Certainly it is important to look at the figures in more detail. The IMF analyzed four classes of assets: residential and commercial mortgages, consumer and corporate debt; for all classes, it looked at loans still sitting on banks' balance sheets as well as at securities, including structured loans.

As in the past the IMF used market data to estimate losses for structured products, i.e. derivative indices like the ABX index. Of course, pricing on ABX is convenient. It is the only transparent and publicly available index for securitized subprime mortgages. However, ABX prices reflect the technical imbalance of supply and demand more than the fundamental value of the underlying assets. Trading is thin. Using ABX prices can produce loss estimates wide of the mark.

But it is not only that these indices may not be very reliable. More disturbing is the fact that the IMF, in calculating the losses for securities, seems to follow slavishly market sentiment, a blemish also embodied in our accounting regulations for capital market instruments. That sits ill with its new mandate, given by the G20, to inform policymakers around the world of market exuberances countering the pro-cyclical herd behavior of market participants. Early warning can only fulfill these expectations if based on independent analysis. How can an approach that derives its forecasts from actual market prices lead to new information that the market does not already know? Applying IMF's methodology at the height of the last boom would have resulted in "forecasts" that the banking sector is massively overcapitalized.

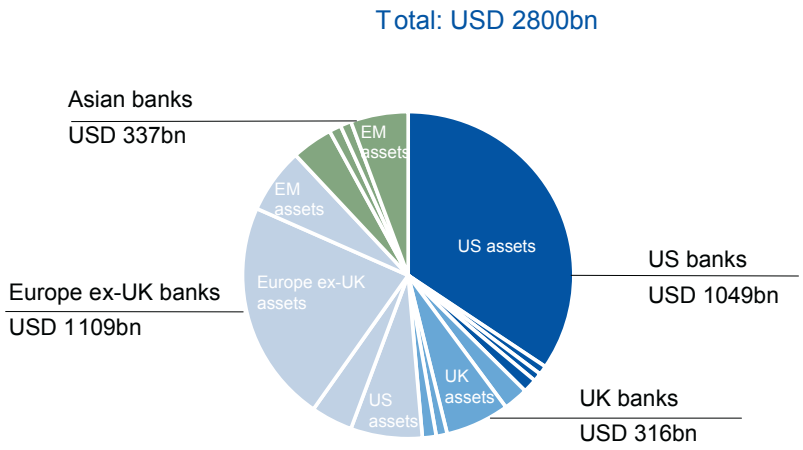
In this regard, the IMF's approach to estimate losses for loans, from prime residential debt to plain vanilla corporate loans, is more robust. Here, the IMF uses its own models to predict charge-off rates for different loan types. Given its gloomy economic outlook and the size of the global banking industry sitting on more than USD 40,000bn of loans, it is no surprise that the IMF now expects that loan losses will top USD 2,000bn.

On the contrary, it is pretty obvious that rising credit losses are likely if the real economy were to deteriorate further. But these are normal second-round effects. By sharply increasing loan loss provisions, banks are preparing themselves for worse to come. Credit losses triggered by an economic slowdown are by no means signs of a financial crisis or evidence of wrongdoings or structural failures. It seems as if the IMF has attempted to calculate all credit costs deriving form the current world recession. However, slapping such "normal" costs of banking onto the bill for the crisis only inflates loss estimates and is pro-cyclical.

Therefore, the question remains: What is the purpose of the whole exercise? Without doubt, the IMF's estimates will influence the debate about how to rescue the banking sector. In the end, it is the taxpayer as the capital provider of last resort who will have to foot the bill. Inflated loss estimates may have a real impact. They do more harm than good when it comes to finding a way out of today's mess.

By extending the calculations far beyond structured assets, the IMF runs the risk of a confused debate about "toxic assets". Now every asset in danger of impairment is seen as a "toxic asset", even plain vanilla corporate loans or bonds. This is particularly the case in Germany where the authorities are claiming that losses from toxic assets of German banks alone could surpass USD 1000bn – which would more or less equal the writedowns the IMF assumes for all European banks (ex UK).

IMF's estimated bank writedowns

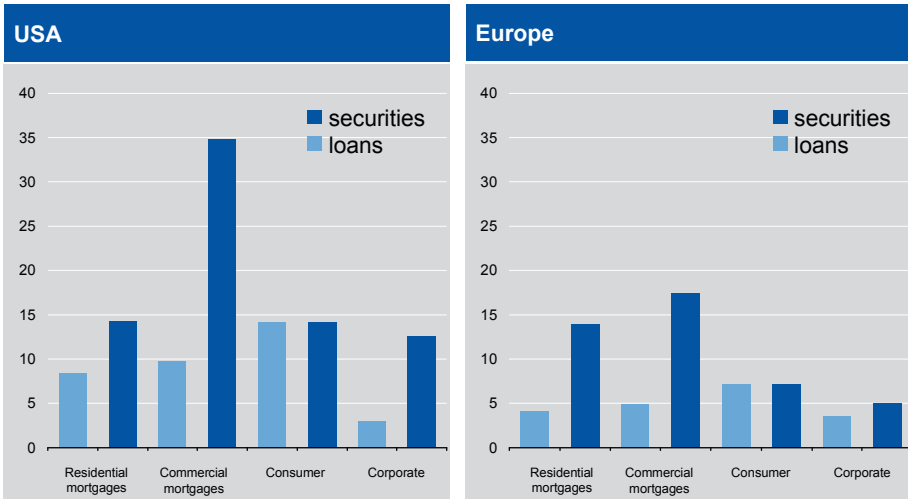


Source: Global Financial Stability Report, April 2009.

Such a broad definition of toxic assets is misleading. Better to confine the assessment to the real troubled assets: the structured credits of mind-boggling complexity i.e. the products of the securitization boom when banks "sliced and diced" risks and cash flows to transform dodgy loans into highly-rated securities. These products are today toxic because of the near impossibility of valuing them; a not insignificant number may have become worthless. There are (almost) no market transactions and no private investors willing to enter the fray of extracting what value they can from these assets. Therefore, we need a common solution using public money to disentangle the structured nightmare. In fact, governments around the world bear some responsibility to cleanse banks' balance sheets from these assets as the failure of supervision, allowing the "shadow banking world" to mushroom, played an important part in piling up these assets in the first place.

What are the losses financial institutions worldwide may face from these real toxic assets? Taking securities based on residential and commercial mortgages as well as on consumer loans as proxies and applying the IMF's loss rates for the corresponding loans (but not the market rates!), the resulting figure is about USD 800bn. Still a whopping figure but certainly less frightening than the IMF's headline figure of USD 4,100bn. Moreover, if global writedowns of USD 950bn by banks – which are until now predominantly the result of mark-to-market accounting of securities such as MBS, CDOs and the like – are taken into account, it seems that these assets have lost their power to surprise on the downside. Against this backdrop, schemes like Mr. Geithner's PPIP (public-private investment program) or the German bad-bank initiative trying to shift these assets from banks' balance sheets into the hands of some "de-toxing" experts look less hazardous.

IMF's implied cumulative loss rates



Source: Global Financial Stability Report, April 2009.

However, these solutions are now no easy sell to taxpayers. Although the IMF would like to see governments take bolder steps, its inflated estimate of "toxic losses" may actually be counterproductive. There is the clear danger that policymakers are scared away from decisive action; public money may become less available. Instead of transparent solutions to shore up financial institutions – not refraining from nationalizing if necessary – policymakers may now flock to more "creative" solutions such as tweaked accounting rules in order to obfuscate the costs.

However, distinguishing between toxic losses and "normal", recession-induced impairments does not cause the latter to disappear. Banks have to face these losses regardless of their origin. But the different loss categories are important when it comes to the "solution" and the involvement of public money. "Toxic" losses are the result of the structural failings of the global financial system; they require public assistance and common solutions, as explained. Normal impairments do not. There should be no market failure; as always, the valuation problem consists "only" in the uncertainty about the future economic development. Private investors should not be deterred and in fact, so-called "vulture" funds" are already circling the banks, sniffing some lucrative deals. After all, coping with souring loans is part of financial markets' usual business.

But it is more than obvious that the process is not going to be a smooth ride of an orderly, across the board cleansing of balance sheets. On the contrary, the purge of non-performing loans in the financial industry could become a traumatic experience for some. Weak banks will fail, with their still healthy business lines being taken over by stronger competitors. There will be a painful restructuring and consolidation process, sorting out the strong banks from the weak. If the US Treasury's stress tests of US banks accelerate that process they will have fulfilled their duty. The sooner the winners can clearly break away from the losers the better the chances of avoiding a widespread credit crunch. Keeping all banks alive – but under the overall suspicion of looming huge losses – only creates "corporate zombies" among lenders and borrowers and prolongs the slump, as the Japanese learnt painfully during their lost decade.

Therefore, governments should not interfere too much but let market forces run their course. First and foremost, banks themselves have to recognize their impairments and, if necessary, raise fresh capital. Governments' duty is to push for the highest degree of transparency. They should assure that strong banks have ready access to capital and that weak banks can be taken from the market in an orderly manner. Given the general loss of confidence, it may be necessary to entice private investors to support these process by offering access to cheap financing. It could also mean that the state has to buy additional stakes in some banks and nationalize others, at least temporarily. But this speaks for a case-by-case approach. There is no need for a grand scheme aimed at solving the problem at one stroke.

Summing up: The IMF loss estimate looks a little over the top with its strict adherence to distorted market prices. Moreover, the high uncertainty about the prospects for the economy makes any estimates highly volatile. The IMF has a pretty gloomy outlook. However, a better than expected outcome is not entirely off the cards; it would magically reduce the amount of future losses. But even more importantly, the IMF directs attention in the false direction. Not all expected losses are toxic resulting from past financial engineering. The bulk of future bank losses will derive from the recession in the real economy. Although still daunting, it means that the financial crisis is returning to common ground. We still need a solution for the real toxic assets; but this problem is now much smaller than the IMF headlines suggest. Mixing up toxic losses with normal impairments is dangerous: It may postpone such a solution as policymakers shy away from the sheer size of the problem or, even worse, it may lead to a solution that lets taxpayers overpay.

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