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SHOP TALK

IREI Weekly editor **Drew Campbell** spoke with **Matthew McManus**, chairman of Philadelphia-based NAI Bluestone Real Estate Capital, about the concept of a "bad bank" that has been suggested as a way to help ailing financial firms saddled with bad assets. The bad bank would buy these credit-related assets and free up banks to lend.

Are you in favor of using a "bad bank" to buy bad assets from banks?

I'm in favor of liquidity in the debt markets, which is what the bad bank would achieve. By removing these toxic assets, banks will be free to begin lending again, which is what we need in the debt markets to keep our economy moving.

What are the pros of this approach?

I am pretty bullish on the benefits and the immediate short-term results it would bring the economy. The bad bank is a vehicle that will be loaded up with X billions of dollars and be a sort of dump truck that can go from bank to bank or institution to institution and pick up all of the loans that cannot otherwise be monetized, liquidated or sold. Removing these toxic assets from the balance sheets will ensure banks are not burdened by the deteriorating value of those assets. This is a good thing because all of these lenders are strapped to mark-to-market accounting, which coupled with the lack of liquidity in the market, is devaluing what are otherwise good loans.

How is the mark-to-market rule impacting firms with bad assets?

Mark-to-market mandates banks to reduce the value of its loan assets, which causes banks to dip below capital levels that are needed to be healthy enough to make loans. If banks can stop the freefall of their loan portfolio value [by selling bad assets to a bad bank], they can begin to shore up their foundation and have the capital to begin lending. Right now, any capital that they receive has to be held because they have to offset the daily decline of the loan portfolio value to maintain federally prescribed capital levels.

What are some of the cons of a bad bank?

There are certainly longer-term considerations at play here. With all this new money being pumped into the economy, people rightfully fear the devaluing of our currency and the inflation it will cause. However, I am a believer in the "one step at a time" approach because of the severity of the problem.

Does today's situation compare to the late 1980s and the Resolution Trust Corp.?

It is very similar, but the causes of the crisis are different this time around than they were in the 1980s. In the late 1980s it was more a matter of local overbuilding that was prompted by the savings and loans crisis -- they increased their lending dramatically to a lot of unqualified real estate deals and unqualified borrowers. It was a supply problem and building outstripped demand. Today, I would argue it was primarily a residential subprime lending issue, and through the vehicles on Wall Street those loans were spread all around the globe. What you have is an S&L crisis on a global scale, which has spread the risk around. One of the arguments Wall Street has made is that by securitizing subprime debt and other types of debt, we are spreading the risk, and they are 100 percent right, but it also means you had a much larger pool of capital to draw from and therefore a much larger problem.

How might these bad assets be priced if they were to be bought by a bad bank?

I will render a guess. These assets are currently valued at a certain number on each holder's balance sheet based on mark-to-market accounting, so I would imagine that the Fed's will offer whatever the value is currently on the books. Ultimately, I think a bad bank vehicle is going to be a good deal for the Fed's and the taxpayers. The Fed's operate on a different playing field; their mark-to-market doesn't apply, so they can hold on to that debt until the capital markets come back and then sell those assets, even at a great discount, into a healthy economy, which also benefits taxpayers. Even during the S&L days, the RTC made a substantial profit. I see that happening again. The mark-to-market mandate has caused these lenders to devalue their loans far below their actual true value or performance value. If the Federal Reserve comes in and takes these loans off their books, these banks don't have to live and die under the mark-to-market hammer, which will enable them to begin lending again.

What is your sense of when the market might turn?

I believe we are going to see a bottom this year. Some of the bolder players already are stepping up and making deals even though the bottom might not be realized just yet. These players are comfortable that the bottom, and the rebound from the bottom, will occur within a reasonable time frame and therefore are beginning to deploy capital. If you look at the LIBOR right now, it is extremely low -- banks have determined that they are a credit worthy borrower again. This is because government banks are not going to let each other go out of business.

How does a bad bank help the economy recover from the recession?

A bad bank or RTC-like vehicle helps inject a degree of certainty in the marketplace. That certainty delivered by the Feds to backstop the financial industry is really the engine that drives the economy. It is the origin of where dollars are deployed and where other industries can begin to stabilize their own business.

A bad bank would help restore confidence?

Yes, I think it would. It denotes a bottom, and it not only sends a signal that there is a safety net in place and therefore a bottom in place, but it also delivers some real money. By stabilizing banks' balance sheets, they can begin to lend what capital they do have, which is a real tool for the rest of the industries out there to begin to recover.

-- Drew Campbell