

Special Research

R E P O R T



Government Intervention, Bank Stress Tests Aim To Restore Confidence - Will Measures Be Enough?

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Government stimulus and financial market intervention - already at unprecedented levels - have become even more aggressive in the wake of a steeper recession and escalating credit market woes. Government loan facilities established last year are being modified, and new programs have been proposed to help jumpstart stalled credit markets. The first round of funding for the Troubled Assets Relief Program (TARP) was originally intended to buy toxic assets from financial institutions, but the capital was instead used primarily to purchase equity shares of major banks. Therefore, toxic assets, which include difficult-to-price mortgage-backed securities, have remained on the balance sheets of financial institutions. Uncertainty and the potential for significant write-offs associated with these assets have subsequently hindered banks' ability and willingness to originate new loans.

With toxic assets still a crucial hurdle to be cleared before the financial system can function effectively, the government has become more focused on the issue. In addition to the stimulus package, new programs aimed at restarting the market for these assets have been proposed. While these measures are expected to positively impact capital markets, it likely will require at least six months for credit flows to improve measurably.

Steps to increase transparency in the financial system are also under way, which appears to be alleviating some of the uncertainty in the marketplace. Based on the results of stress tests performed on 19 of the largest financial institutions in the nation, 10 major banks have been ordered to raise a total of \$75 billion in capital to protect against worst-case losses. While the results of the tests were better than many had feared, they could work against credit markets in the near term by encouraging banks to continue hoarding cash to protect against potential losses. On a positive note, the increased transparency in the marketplace has been generally well-received by investors, with financial stocks trading at higher levels than a few months ago.

Government stimulus and initiatives alone will not overcome the impact of the private sector pullback on the economy, but the multitude of programs should promote improvement in the flow of capital. This spark, in turn, will help generate economic activity, bringing the recession to a close by the end of this year. Risks to the economy and financial sector are still present, as the housing market has yet to reach bottom, and the potential exists for additional unwinding of complex financial instruments.

Commercial real estate fundamentals typically lag the economy six to nine months. As a result, deep job losses in recent months are forecast to translate into rising commercial property vacancy through year end, with rollbacks in rents likely to continue through the better part of 2010. Commercial real estate fundamentals and the investment climate ultimately will benefit from improving capital flows and the economic recovery, especially since the sector was generally not overbuilt heading into the downturn.

Key Financial Sector Developments

- The \$787 billion economic stimulus package passed in January is designed to create or prevent the loss of 3.5 million jobs over the next two years. The components of the package with the greatest potential for immediate impact include \$288 billion in tax cuts, an \$8,000 tax credit for first-time homebuyers, \$144 billion to assist state and local governments, and \$111 billion to be spent on infrastructure improvements and science.

- Stabilizing the banking system and restoring function to credit markets are also top priorities for the U.S. government, as evidenced by the proposed Public-Private Investment Program (PPIP). The program is designed to address the toxic assets clogging balance sheets and hampering the formation of new credit. Recently released details of the plan have been generally well-received by financial markets; however, implementation will take time, and some trial and error likely will be required.

- The expanded Term Asset-Backed Loan Facility (TALF) is a critical piece of the solution, as it provides low-interest loans for purchasing newly issued, AAA-rated asset-backed securities (ABS). The ABS

are mostly backed by student, consumer and small-business loans. Commercial mortgage-backed securities (CMBS) were recently added to the program, however, and the Fed has increased the term on TALF loans for purchases of CMBS to five years.

- The Legacy Assets Program is expected to assist PPIP in purchasing previously highly rated assets, including non-agency residential mortgage-backed securities (RMBS) and CMBS, from financial institutions. PPIP aims to remove \$1 trillion of toxic "legacy" assets from the balance sheets of financial institutions. If successful, the program will provide a price discovery tool for these troubled assets, the first domino in clearing the balance sheets and eventually resetting credit markets.

- Recent relaxing of mark-to-market accounting rules by the Financial Accounting Standards Board allows banks greater flexibility in calculating the value of difficult-to-price assets. Under mark-to-market accounting, financial institutions had to value assets based on current market prices, which reflected significant discounting due to distress. The modified rules should greatly reduce write-offs, which, ironically, may diminish the motivation for institutions to become aggressive in moving toxic assets off their balance sheets through PPIP.

