WILL THE Banks Survive?

A WAVE OF TROUBLED LOANS THREATENS TO SEND WEAK ONES INTO THE ARMS OF UNCLE SAM.

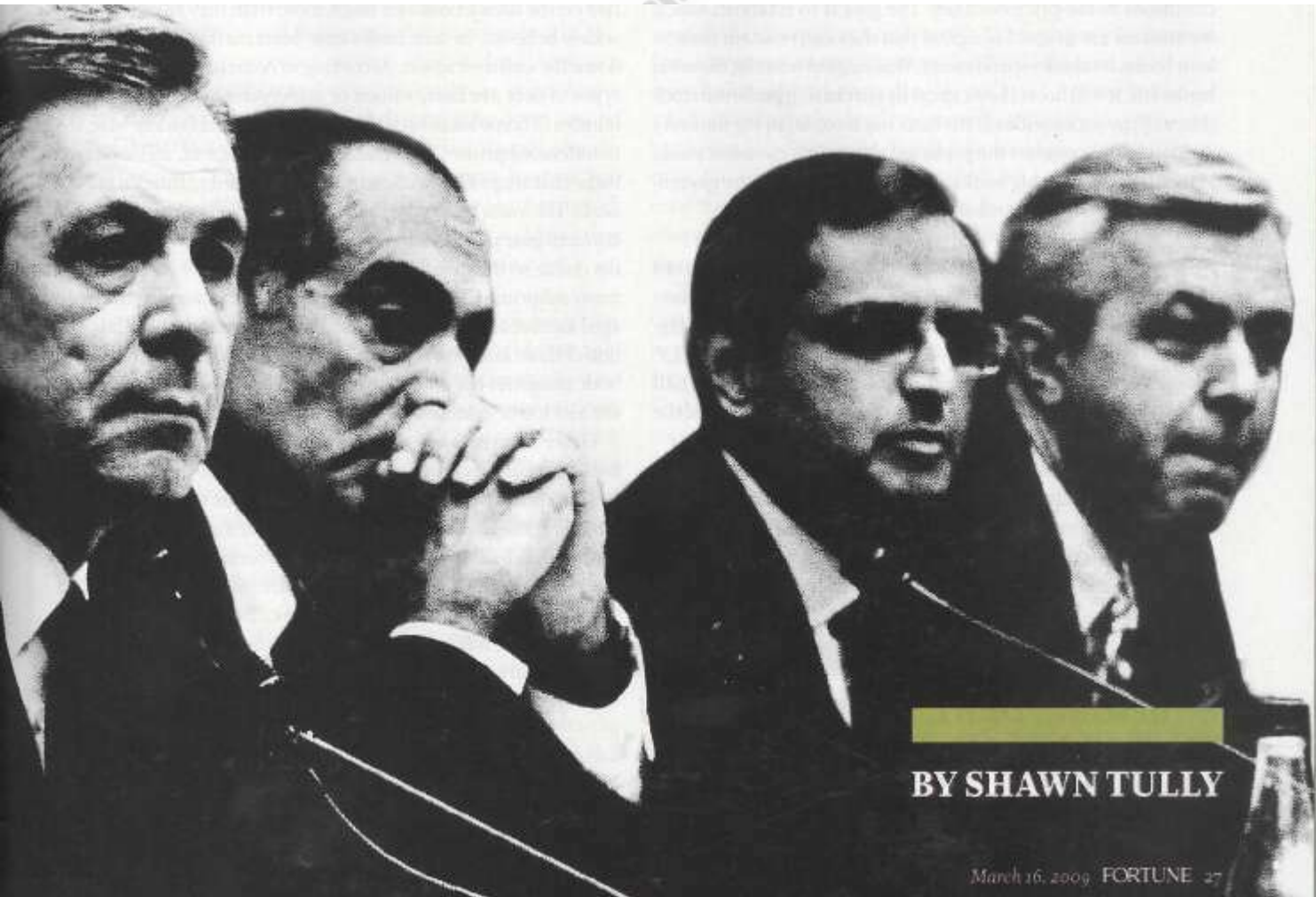
ON FRIDAY, FEB. 2O, investors watched in horror as shares of Bank of America plunged below $3 and Citigroup's stock broke $2, giving the two pillars of U.S. banking a combined market value of $26 billion—far below that of Kraft Foods. Fear is spreading that if all that rescue money can't revive these stumbling giants, only one road remains. Everyone from former Fed chief Alan Greenspan to Senate Banking Committee chairman Chris Dodd is warning that the sole solution may be the once unthinkable one: nationalization.

How can it be that the banks are tottering after the government fortified them with hundreds of billions in bailout cash and guarantees on their troubled assets? For the past 18 months, the banks' problems with toxic securities, especially collateralized debt obligations (CDOs) and other exotic products that packaged subprime mortgages, attracted most of the attention—and alarm. Now the storm is entering an entirely new phase that's potentially even more dangerous: a historic meltdown in the bread-and-butter businesses of credit card, home-equity, and mortgage lending.

The scale of potential losses in consumer and business loans swamps what's left from the securities debacle by a factor of three or four to one. And the next wave, the looming defaults on commercial real estate loans financing the likes of half-leased retail malls, will soon cause a fresh round of pain. "We've now moved from the securities phase to the lending phase of the banking crisis," says Tanya Azarchs, a managing director in S&P's financial services ratings group. "For 2009 we expect that loan losses will be much worse than for 2008 and that securities write-downs will be much less."

THOSE LOOMING LOSSES make it inevitable that the government will shower the banks with more bailout billions—and get big ownership stakes in return. But that will fall far short of what most people think of as nationalization. Speaking before Congress,

GANG GREEN AMONG THE BANKERS GRILLED BY CONGRESS LAST MONTH WERE (FROM LEFT) LLOYD BLANKFEIN OF GOLDMAN SACHS; JAMIE DIMON OF J.P. MORGAN CHASE; ROBERT KELLY OF BANK OF NEW YORK; KEN LEWIS OF BANK OF AMERICA; RONALD LOGLIE OF STATE STREET; JOHN MACK OF MORGAN STANLEY; VIKRAM PANDIT OF CITIGROUP; AND JOHN STUMPF OF WELLS FARGO.



BY SHAWN TULLY

Federal Reserve chairman Ben Bernanke said that nationalization means that the government takes 100% ownership, wipes out the shareholders, and runs the bank. "I don't think we want to do that," he said. He added that talk of nationalization misses the point. And he's right: The government already exerts tremendous influence over the industry, requiring banks that take federal money to limit compensation and modify mortgages, among other restrictions.

Moreover, the government seizes banks all the time. Since the beginning of 2008, the FDIC has shut down 39 insolvent institutions (leaving shareholders with nothing), reselling the branches, loans, and bad assets as quickly as possible. In the rare cases when it can't find a buyer, the FDIC will run the bank, as it is doing with IndyMac, which it took over in July. (A sale of IndyMac is now in the works.) And the agency is likely to be busy for some time to come: During the last banking crisis, from 1989 through 1992, it seized 1,368 banks.

THE NEXT WAVE LOANS TO REAL ESTATE DEVELOPERS ARE GOING BAD FAST.

The big banks, however, will get all the help they need to avoid that fate. The administration plans to put the 19 banks with assets of more than $100 billion through a rigorous financial analysis called a stress test. The banks will have to calculate their losses under severe conditions, including increased unemployment and continued home-price declines. The goal is to establish which institutions are so short of capital that they can't sustain current loan books, let alone expand credit. Washington won't let those big banks fail: It will boost their capital by purchasing preferred stock that will pay a 9% dividend. If a bank has trouble paying the hefty dividend, it can convert the preferred shares into common stock. Hence, the weakest big banks may well end up with the government as their largest shareholder.

To UNDERSTAND THE FORCES that will drive some banks into the arms of Uncle Sam, let's take a deep dive into their balance sheets. We'll concentrate on the four biggest U.S. institutions—Bank of America, Citigroup, J.P. Morgan Chase, and Wells Fargo—because they hold almost half of U.S. consumer and business loans and account for most of the problem securities that haunt the industry.

First, let's examine the banks' securities portfolios. According to brokerage FBR Capital Markets, the four big banks hold almost $2 trillion in investment and trading securities such as collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and commercial and residential mortgage-backed securities—including the subprime paper that started the whole debacle. Accounting rules require the banks to mark almost all such assets to market—adjust their value according to prices brought by comparable securities in recent sales. But the markets for many of these assets are frozen, making it difficult or impossible to value them accurately.

That doesn't mean, however, that they are necessarily being carried on the banks' books for much more than they are worth, as is widely believed. In fact, banks have been marking the securities down for well over a year. According to Azarchs of the S&P, three types of debt are fairly valued or undervalued on banks' books: bundles of home loans backed by Fannie Mae and Freddie Mac, the notorious subprime CDOs that started the problem, and leveraged loans that shops like Blackstone and KKR used to finance buyout deals. The loans backed by Fannie and Freddie are essentially government guaranteed. Banks are carrying them at about 90 cents on the dollar, so they are fairly valued. The banks have marked down many subprime CDOs to 25 cents, and they are carrying the leveraged loans at around 75 cents. But Azarchs contends that a fair portion of those loans are producing income and will be paid back. "In both categories the potential losses in many cases, in my opinion, are a lot lower than their prices on the banks' books," she says.

Other securities are still overvalued: for example, mortgage-backed securities based on jumbo home loans, those too big to be guaranteed by Fannie and Freddie. Azarchs says that these securities at the four big banks are now marked at around 78 cents, probably an inflated number given the soaring mortgage default rates. Another area where the marks are too high is packages of commercial real estate loans. "Even if they're still paying full interest, many of the buildings backing them are worth a lot less than the loans," says Tom Barrack, CEO of Colony Capital, a private equity firm specializing in real estate. "They're really worth around 50 cents, and they're marked at 70 cents."

SUBPRIME DEBT, MARKED DOWN TO 25 CENTS ON THE DOLLAR, MAY TURN OUT TO BE WORTH MORE.

The banks also face losses on the insurance contracts

they bought to protect against losses on many of these securities from monoline insurers such as Ambac and MBIA. Those insurers have run into trouble and seen their credit ratings cut, which forces the banks to take reserves against potentially uninsured losses, a trend that's bound to accelerate.

If the securities held by the banks do indeed contain plenty of bargains (alongside the overpriced merchandise), why aren't buyers lining up to take them off the banks' hands? The reason is threefold: First, buyers who have jumped in so far have been badly burned because of gyrating prices. In the fourth quarter, just when it looked as if once-toxic securities were raving bargains, prices collapsed as rates on everything from junk bonds to triple-A corporate debt exploded. Second, the buyers are financing their purchases with short-terrn loans, so they typically can't hold the assets until they mature.-Instead, they're getting killed by margin calls from lenders. Third, potential buyers are sitting on the sidelines while Washington designs a plan for dealing with toxic assets that may give them a better deal.

The buyers' strike won't last. In early February the Treasury announced that it would provide up to $1 trillion in financing for private buyers to purchase illiquid assets. That program is bound to stir the vultures. A few investors are ready to pounce: "We see lots of fabulous bargains, with good assets often selling at 60 cents," says Michael Tennenbaum of Tennenbaum Capital Partners, an investment firm specializing in distressed debt. And Colony Capital has raised a $1 billion fund to purchase beaten-down bonds.

As more transactions occur, we'll get a better idea of how overvalued or undervalued various securities really are. According to estimates by FBR, the banks will end up writing down around 4.5% of their trading and investment portfolios, mostly over the next three years. For the big four, that would mean losses of $90 billion, or around $30 billion a year. That's a large number, but it's far less than the $150 billion the four (and the banks and firms they have acquired recently) have written down since late 2007.

Now LET'S EXAMINE the second, far more dangerous menace lurking in the loan portfolios. The big four hold $3.6 trillion in credit card, home-equity, mortgage, commercial real estate, and other consumer and business loans. Those loans are deteriorating with shocking speed: Default rates will soon surpass the worst of any recession in decades. Since mid-zooy, for example, the charge-off rate for credit card loans has jumped from 3.8% to 7%. Overall, the four big banks suffered charge-offs of around 1% of their portfolios through the middle of 2007. For the fourth quarter of 2008 the figure jumped to 2,6%. And things are getting worse—delinquencies in all categories are rising, Star analyst Meredith Whitney predicts that credit card losses will climb above 10%, far higher than in any recent recession.

How high will the losses mount? FBR predicts the banks will eventually write off about 9% of their loan portfolios, with the vast bulk of losses coming in the next three years. That would hit the big four with around $300 billion—or $100 billion a year—in credit losses, more than three times the projected damage from their toxic securities.

And that explains the talk of nationalization. The challenge for the banks now is to earn enough money from normal operations that they can avoid taking additional government aid—which is not an impossible dream. Unless the U.S. falls into a near depression, it's likely that the majority will succeed. Among the big four, J.P. Morgan and Wells Fargo have the best prospects. They boast relatively strong capital ratios and are striving to stay ahead of the government by raising capital on their own. J.P. Morgan just announced a steep dividend cut that will save 85 billion annually and greatly strengthen its balance sheet. By concentrating on consumer banking, Wells Fargo mostly avoided the securities mess. It's likely to raise additional cash by selling the East Coast branches it inherited from its merger with Wachovia to concentrate on its powerful Western U, S, franchise.

And even Bof A, saddled with the disastrous purchase of Merrill Lynch (see "Divorce—Bank of America Style" on fortune.com), could find a clear path out of the rnuck, although that's far from certain. The smart money is betting that Bank of America will soon launch a big asset sale, including Merrill Lynch's prime brokerage, which caters to hedge funds; reportedly, it has already put private bank First Republic on the block. That could give BofA sufficient capital to sidestep a bailout. Then the bank could rely on its powerful nationwide low-cost consumer franchise to rebuild its balance sheet. "Investors underestimated BofA," says Whitney. "BofA should be able to start building capital by the middle of 2009."

LOSSES ON ORDINARY BUSINESS AND CONSUMER LOANS WILL END UP DWARFING THOSE ON TOXIC ASSETS.

The true basket case among the biggest banks is Citigroup. Citigroup's core businesses in areas like credit cards, branch banking, and international corporate lending are so weak that it cannot generate enough revenue to compensate for the deluge of losses. That means its puny equity capital is destined to keep shrinking or disappear entirely. Citi executives are already asking Washington for additional aid in exchange for as much as 40% of Citi's common stock. And after the stress test, it will probably need more cash, making it all but certain that the government will end up with a majority stake. How the government proceeds from there will say a lot about the future of the banking sector. The fear is that Washington will continue to prop up Citi and other wounded banks in their current form. The best course would be to force battered banks to sell enough assets to restore their financial health—if that's possible—or to dissolve. That would demonstrate that Washington is serious about reviving the industry—the one that is absolutely essential to the nation's economic recovery.

TULLY, Shawn. Will the Banks Survive? **Fortune**, Amsterdan, n. 5, p. 26-29, Mar. 23, 2009.