European Distressed Assets? What European Distressed Assets?

A substantial volume of capital has been raised by various asset managers to capitalize on the imminent or eventual fire sale of distressed assets by European banks and financial institutions. Its going to be a long wait.

Mark Scott writes in the NY Times that the likes of Carlyle, Oaktree, Apollo, Cerberus, Avenue et al are raising billions of dollars in funds seeking to buy loans, bonds and other assets from European financial institutions, but that the great European fire sale has not begun. Here is why.

The European regulators definitively do not want a fire sale by their banks precisely because to do so would burn more bank capital and require further recapitalizations. Absent the risk of total and catastrophic failure, no bank would sell its distressed assets at distressed prices. From a capital perspective, it is more rational to sell performing assets at non-distressed market prices. This is typical in any liquidity crisis, one sells the higher quality assets, because they can be sold more easily and at better prices, and is left holding the poorer quality assets. It exacerbates the situation later down the road but in the immediate time frame, is the easiest, most intuitive, and emotionally inexpensive thing to do.

There was a bit of a fire sale in late 2010 early 2011 as the European sovereign crisis threatened bank failures. The ECB, however, stepped in to provide long term funding to the European banking system in December of last year, both to avert a collapse of the banking system as well as to provide capital to refinance maturing sovereign debt. The effect of this was to remove the near term stress that would necessitate the fire selling of assets. Put simply, fire sales are like amputations; you don’t do it unless there is no choice. And now there is a choice. Sit and wait and hope.

As a result of the above, on a risk and quality adjusted basis, one could say that higher quality assets are underpriced relative to poorer quality assets. The

resolution to the European bank’s issues is not clear. Ideally, assets would have been placed into segregated ‘bad banks’ which would require discrete capitalization and would then wind down the problem portfolios. The pain would be shared between taxpayers who would almost certainly be called to capitalize the bad banks, and the bank shareholders would also take a hit from the valuations at which the bad assets were contributed to the ‘bad banks’. Alas, public finances are sufficiently impaired that this route is not viable.

The ECB’s LTROs but postpone a problem for which no solution has been put forward. Neither does it appear that anyone is seeking a long term resolution. Instead we have a stand off between buyer and seller of distressed assets with bid offers of 20% and wider.

It would arguably be better if the ‘bad banks’ were created and allowed to access the LTROs than the current situation where the LTROs support balance sheets with an unknown mixture of good and bad assets, with the uncertainty over the proportion of bad assets and the loss severities overhanging sentiment and thus bank’s access to subsequent capital or liquidity.

In such an environment where there is no segregation of assets by quality, there is an opportunity for privately negotiated bilateral solutions which help provide capital solutions to banks, and maintain the opacity that these banks desire. Such structured solutions typically involve the provision of first loss capital against a pre-identified pool of assets, in return for a hefty coupon usually structured as a senior claim and priced in such a way as to dominate the capital on a net present value basis. The bank then seeks from the regulator capital relief on the defined pool of assets.

Both the LTRO and such capital relief solutions buy time for the banks to either recapitalize directly or structure profitable and capital efficient carry trades to bolster capital.

All of the above discussions still do not present a solution to the debt crisis once the current LTROs mature. The macro economic issues are not the scope of this blog post.