

## Etsior Monthly Opinion 15 April 2009 - Banks (in)solvency

Has the G20 summit done what it has to do to solve the crisis? Though some small progresses have been made, it looks like the main problem which is the solvency of banks has only been partially addressed.

The main issue in the present crisis remains the understandable lack of confidence in the bank assets. If this had been a liquidity issue, the crisis would have been behind us for long given the huge quantities of cash the central banks have flooded in the economy. But the problem lies in the valuation of the bank assets and the doubt expressed by fellow banks on the accuracy of their valuation. Nobody wants to take the risk of lending money to institutions that are virtually insolvent because parts of their assets are not negotiable any more. Uncertainty about the quality of the bank assets is too high to get back to a normal situation. Banks do not know who is actually solvent or no.

So what to do? Assuming the risk of letting another major institution go bankrupt is too high for the whole economy, a good way is to take these bad assets out from the banks' balance sheets and to put them in "bad bank" structures, waiting for what can be recovered from them. Banks balance sheets are then sound again and confidence comes back. This is what the US Government has proposed to do: buy back toxic and/or illiquid assets. This obviously rises the question at what price. If valued too low it can lead some banks to evident insolvency and to bankrupt. This is why some banks just do not want to sell their bad assets to a defeasance structure and why finally governments will try instead to recapitalize or nationalize institutions using taxpayer money. This is not a good situation. Taxpayer and ordinary people just do not understand why the ones liable for the crisis are endlessly helped.

Recapitalizing banks this way is probably not the right way of doing because it delays the restoration of confidence. There is a time of realities must be faced, making sure of distinguishing between toxic assets, like the CDO leveraged scaffolds built on subprime mortgages and the temporary illiquid assets frozen up by the surrounding crisis. This should be done at the risk of seeing some institutions disappear or being merged with sounder ones. Putting money indefinitely in the system will not save it. Decisions must be made.

Not making these decisions would lead to a more difficult and uncertain recovery, spreading on to the real economy and destroying value

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especially in the industry. It is not sustainable for industries which have made long term investments in fixed assets to see their order book decrease in the current proportions for a long time. The economical and social consequences may be very hard and no one wants to go in this direction.

Another interesting point is the crisis in the automotive sector. People have delayed their car purchases for many reasons. First is a change in the behavior: there is a clear trend to favor the public transport and to do it by reducing the space available for cars. Just look around you how the number of lanes is reduced, constraints are implemented (pervasive speed check, speed bumps etc...) taking out any pleasure in driving. Then we all feel we are at a technology change regarding energy, CO<sup>2</sup>, sustainability. As cars actually do not need to be changed, people just wait. In big cities, people elect not to buy a car but to rent it when they need it. So my perception is the automobile sector crisis is definitely structural.

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