How to Turn Around the Credit Crisis in 30 Days – No Need to Price Toxic Assets (or The Loan Stimulus Plan)

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Fellow investors, government leaders and economists,

I want to propose *a very simple solution to our very large problem of frozen credit markets*.

First a little history, about 50%[1] of all lending was absorbed by the Shadow Banking System[2] prior to this crisis. The Shadow Banking System is currently closed or out of business.

The other half of lending was held or absorbed by the banks. Even if the banks were healthy the banks could only absorb about half of all credit demand. Well the banks are not healthy so they can't even lend the half they were lending before.

Toxic assets are toxic today and even more toxic tomorrow as every day they fall further in value. We need to avoid being distracted by issues relating to how to price toxic assets and what the US Government should pay for these assets. We need a solution that eliminates the need to price toxic debt in order to start providing capital to the marketplace again.

My solution is:

The Federal Reserve buys a 90% participation in all ***newly issued commercial debt*** (debt outstanding for less than 30 days) underwritten by banks. The underwriting bank must keep 10% of each loan. Loan parameters are a maximum loan origination fee of 2.5% and maximum annual servicing fee of .5%. All new debt must be directly issued by the borrower, so securitizations and esoteric structures are excluded from eligible loans. 100% of all interest must be payable currently, maximum term is 60 months so the participations self liquidate.

Benefits:

1. New money starts flowing immediately (should be within 30 days of program's announcement) into businesses as opposed to bailing out banks.
2. Banks start to receive revenue from loan originations and loan servicing, business that used to provide them with steady profits and a healthier business model.

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[1] In early 2007 Tim Geithner estimated the Shadow Banking Assets to be $10.5 trillion and the total assets of the entire banking system at about $10 trillion.

[2] Named by Paul McCulley of PIMCO. it is the un-regulated loan industry which has existed outside of bank regulations. A large portion of the instruments (SIVs - structured investment vehicles, CDOs –collateralized debt obligations, CLOs- collateralized loan obligations CMBS – commercial mortgage backed securities, etc.) originated by this industry were pooled loans packaged and sold to investors.

3. The purchases by the Treasury are not government expenditures that drive up our deficits.
4. We don't need Congress to pass this program.
5. Banks have a real exposure on each loan.
6. The US Government can and will be temporarily taking the place of the Shadow Banking System.
7. Banks will retain the responsibility and the upside of holding their bad loans so they have an incentive to work their existing borrowers to maximize the value of their loans.
8. Healthy small and medium size banks can take on a much larger role in our banking system.
9. No valuation issue as the US Government will hold these 90% participations to maturity or the date they sell them to other investors once the credit markets return to normal.
10. It will virtually eliminate the risk of companies with healthy income statements, but maturing debt obligations becoming insolvent.
11. Borrowers will be able to stop reducing head count and curtailing purchases due to maturing debt concerns, which otherwise has a negative multiplier effect on the economy.
12. It will be easier for banks to raise additional equity capital due to the higher fee income.

Example, a small bank with a $5 million maximum loan limitation can now issue a $50 million loan and only have a $5 million exposure. That same bank does not have to even go to its maximum per loan exposure limit. It can underwrite a $40 million loan and only have $4 million of exposure. Now a local bank can handle the banking needs of medium size companies or work with another local bank to underwrite a $100 million loan. Naturally, in order to hold the 10% share of the loan the bank has to have adequate capital. Healthy banks did a better job of underwriting and those are the ones to be rewarded with the ability to make larger loans.

Per bank limits can be imposed on the maximum of US Government purchases based up size of the bank, reserve ratios, etc. Underwriting standards would be determined by the individual banks.

We need to get this idea out to people that can get this message to the Treasury, Federal Reserve, Administration, Congress, Wall Street, economists, etc. I am sure there are numerous ways to improve on this idea, but we need to add it to the list of ideas being considered by our leaders.

Please contact me with your thoughts and reactions to this idea. More than anything send this message to others who hopefully will have access our nation's leaders.

Thanks,

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Plan Alternatives and Thoughts to Consider

1. Perhaps the originating bank should bear the first loss on 100% on each loan up to the amount of the originating fee they receive, (generally 2.5% of the face amount of each originated loan) and then it's pro-rata share of any additional losses (the retained 10% participation).
    a. Remember that the government is relying upon the underwriting skills of the originating bank.
    b. The government can set certain underwriting standards for all loans that qualify but it is not doing its own independent underwriting of any individual loans.
2. Loans can be based on pools of assets from issuers, provided the issuer is full liable. For example a pool of credit card receivables from a retailer, but the retailer is primarily liable and the loan is secured by a first lien on the receivables.
3. This Plan is based on the premise that the banks do not make a spread on the cost of financing provided by the government. The government does not lend to the issuing bank.   The government makes a profit on the difference between its cost of capital and the interest rate set by the bank on the loan. A bank's profits come from the origination fee, administration fee and the spread between its cost of capital and the loan interest rate.
    a. This is designed to avoid increasing bank leverage which creates outsized risks to the credit system.
    b. To justify a bank making a spread on the entire loan would require them to bear a much larger piece of any first losses, again increasing risks to the originating bank.
4. What conditions are necessary in order for a bank to roll over any of its existing outstanding loans at maturity? Suggestions are:
    a. The loan cannot be in default.
    b. It must pass all of the lender's current underwriting standards (loan to value, coverage ratios, haircuts, etc.).
    c. A new lender that is not involved in the credit must underwrite and purchase at least a 5% participation in the entire loan.