EXTREME MAKEOVER BANK OF AMERICA: THE ASBESTOS SOLUTION

The idea of using asbestos litigation as a model for legal problems stemming from toxic mortgages is not yet on the table, but some argue it's time for a creative solution to the bank's woes.

Pedestrians walk past a Bank of America sign on the street in New York March 8, 2011. **REUTERS/LUCAS JACKSON**

BY MATTHEW GOLDSTEIN, JENNIFER ABLAN, DANIEL WILCHINS AND KRISTINA COOKE
NEW YORK, SEPT 9

IT WORKED FOR ASBESTOS so why not for toxic mortgages?

When some look at all of the litigation arising from Bank of America's big role in the U.S. mortgage mess, they start thinking of asbestos and how thousands of lawsuits arising from that cancer-causing product brought down many manufacturers more than a decade ago.

The solution back then to dealing with claims filed by more than 750,000 workers exposed to asbestos was the creation of dozens of "asbestos settlement trusts," which have paid out tens of billions dollars in damages. Some of them are still going strong today.

The asbestos trusts were seen as an innovative approach to deal with seemingly endless litigation and provide a measure of compensation to sick workers and their families. The system for dealing with claims also allowed some of the hobbled manufacturers to emerge from bankruptcy largely free of the crushing weight of lawsuits.

Now some investors in soured mortgage-backed bonds sold by Bank of America and advocates for struggling homeowners are wondering whether a similar strategy can be used to deal with litigation claims that Wall Street analysts estimate could cost the nation's biggest bank more than $50 billion.

"We've suggested an asbestos-style settlement as a solution. It makes the most sense," says Vincent Fiorillo, a portfolio manager with DoubleLine Capital, a $15 billion bond shop that has its own pending claims against the Charlotte, North Carolina-based lender. "It is better than where we are right now."

The idea of using the asbestos litigation wars as a model for dealing with the fallout from the financial crisis is more talk than anything else. There's no indication an asbestos-style litigation trust is something Bank of America is actively considering at the moment.

But efforts to find a creative solution to Bank of America's multi-pronged exposure to Countrywide's ailing mortgage portfolio become more urgent with each downward tick in the bank's already depressed share price.

On Wall Street, once extreme ideas - such as spinning off the bank's Merrill Lynch investment arm to raise additional capital or placing all of its rotting mortgages into a so-called bad bank managed by federal regulators - are being bandied about quite freely. Calls to break up Bank of America are no longer just idle chatter of hedge fund traders selling short its shares.

Just this week, Chris Whalen, a bank analyst and co-founder of Institutional Risk Analytics, was out calling for a Chapter 11 restructuring of Bank of America.

"You need to do something radical, which changes the framework so people can start thinking with their brains again," says William Black, an associate professor of law and economics at the University of Missouri-Kansas City School of Law and former litigation director of the old Federal Home Loan Bank Board during the run-up to the savings and loan crisis of the 1980s.

So far, Bank of America's management has shied away from drastic measures and instead has begun taking a variety of incremental steps to assure Wall Street it has adequate capital to deal with the onslaught of mortgage-related lawsuits from bond investors, the American International Group, the Federal Housing Finance Agency and others. In August, the bank got a badly needed $5 billion cash infusion from Warren

VIDEO

Bove: Bank of America to cut 30,000 jobs, close 600 branches:
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"YOU NEED TO DO SOMETHING RADICAL, WHICH CHANGES THE FRAMEWORK SO PEOPLE CAN START THINKING WITH THEIR BRAINS AGAIN."

Buffett that helped stop the stock's 49 percent slide this year. It quickly followed-up that deal by selling half of its stake in China Construction Bank for $8.3 billion.

Chief executive officer Brian Moynihan is also mulling a plan to eliminate tens of thousands of jobs over the next several years. On Tuesday, he began a management shuffle by ousting two top executives, Sallie Krawcheck and Joe Price. Analysts expect even more structural changes in the coming weeks, as Moynihan seeks to give a jolt to the bank's beaten down stock, currently trading around $7.

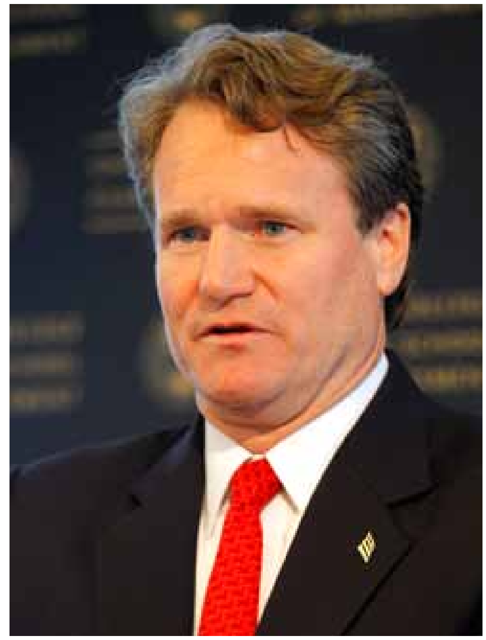
The bank has set aside more than $15 billion in litigation reserves and contends it is well-positioned to defend itself against the wave of mortgage-related lawsuits. It is bracing itself for a war of attrition with mortgage bond investors, who claim the bank and its Countrywide subsidiary sometimes knowingly stuffed those securities with shoddy home loans. A bank spokesman declined to comment on whether it would consider an asbestos-style trust to deal with mortgage-related claims.

A Federal Reserve spokesman also declined to comment.

FRESH START

THIS IS NOT THE FIRST TIME that some have talked about a litigation trust as a mechanism to deal with some of Wall Street's liability arising from the collapse of the U.S. housing market. In the early days of the financial crisis, regulators discussed the merits of using an asbestos-style trust to resolve potential litigation claims against the biggest U.S. banks. But regulators ultimately rejected the trust concept along with other novel ideas that were deemed either unworkable or politically untenable.

One appeal to a trust solution, according to proponents, is that it would be a way for a bank to essentially hive off its litigation liability and establish a mechanism for dealing with claims and litigation. The advocates suggest it would be a way for Bank of America to get



BUCK STOPS HERE: CEO Brian T. Moynihan is under pressure to improve Bank of America's performance after it lost money in three of the last six quarters and its stock has fallen by half this year. **REUTERS/ADAM HUNGER**

a "fresh start" without involving a bankruptcy or a Federal Deposit Insurance Corporation-imposed receivership.

But an asbestos trust is no magic bullet either. The insurance industry continues to be plagued with new asbestos-related claims years after the trusts were created. Credit rating agency Moody's Investors Service recently said after asbestos being a "back burner" issues for years, the U.S. insurance industry is recently seeing an uptick in new asbestos claims.

And the problem with any trust is that it must be adequately capitalized. The amount of money the bank would have to commit would no doubt be contentious and costly to shareholders and potentially bondholders as well.

The easiest way to fund a litigation trust would be for Bank of America to issue new shares, something that would severely reduce the value of its existing stock. That's not the kind of plan that will sit well with stockholders, whose shares are already trading well below the bank's stated book value of $20 a share.

"You'd have to go to the market and raise capital for this and that would dilute shares," says Australian hedge fund manager John Hempton, whose Bronte Capital owns a sizable stake in the bank. "That is the last thing BofA wants to do right now."

Frank Partnoy, a former Wall Street

derivatives trader and now a law professor at the University of San Diego, said a litigation trust also could be partially funded by the issuance of a specialized security called a litigation tracking warrant. He said these warrants could be sold to public investors and offered to current Bank of America shareholders allowing them to share in any of the trust's proceeds that remain after all the litigation has been resolved.

"There are precedents for having publicly traded securities to track how litigation will turn out," said Partnoy.

He explained that a number of banks issued litigation tracking securities in the wake of the savings and loans crisis, when they tried to sue the federal government for wiping out billions of dollars in goodwill on those institutions' balance sheets. The tracking stocks were a way for the institutions to raise cash to finance the litigation.

But if some momentum was building for a radical solution, Buffett's $5 billion investment changed that. Now even some early advocates of an asbestos-style litigation trust are having second thoughts.

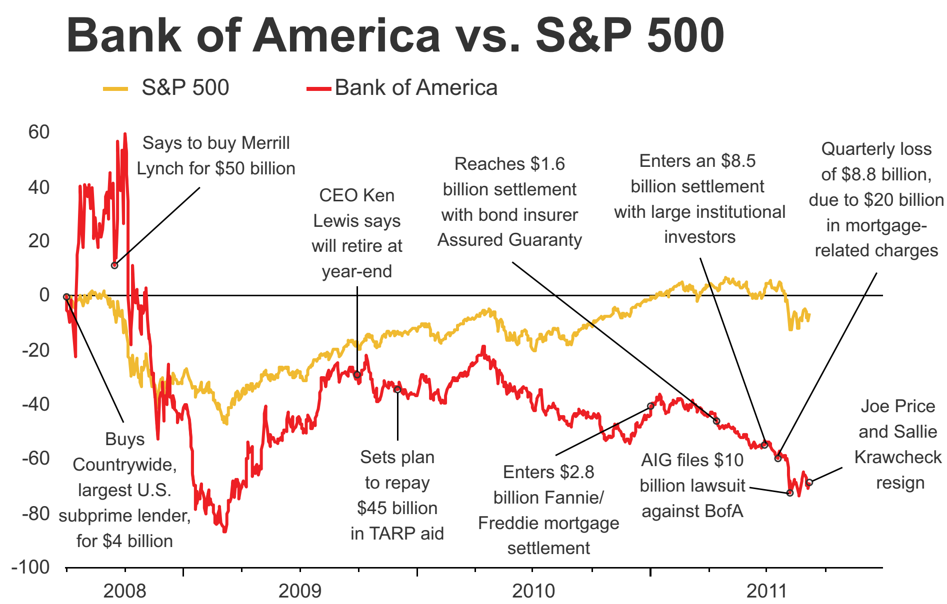
"The dynamics have changed dramatically since Buffett entered the picture," says Sean Egan, a principal of Egan-Jones Ratings Company, an independent rating shop which has eased up on its once bearish view of Bank of America. "It's a kiss of approval," he added, even though the bank is paying a rich 6 percent dividend on the preferred stock it sold to Buffett's Berkshire Hathaway.

Egan says an asbestos-style trust seemed like a plausible solution during the summer when Bank of America seemed to have few friends in the equity markets. But now, Egan says, to set up a litigation trust would "create a total mess" and "be patently unfair to existing shareholders."

Just a few months ago, Egan discussed the merits of such a trust with several mortgage-backed securities investors now sparring with Bank of America. Those investors claim the bank is obligated to buy back the underlying home loans in those now soured bonds because the mortgages were issued to homebuyers who either obviously lacked the income to keep making monthly payments, or were duped into taking out greater loans than they could afford.

EARNING THEIR WAY OUT

BUT EGAN SAYS NOW that the share price hemorrhaging has stopped, Bank of America can focus on taking steps to earn its way out of the litigation crisis.



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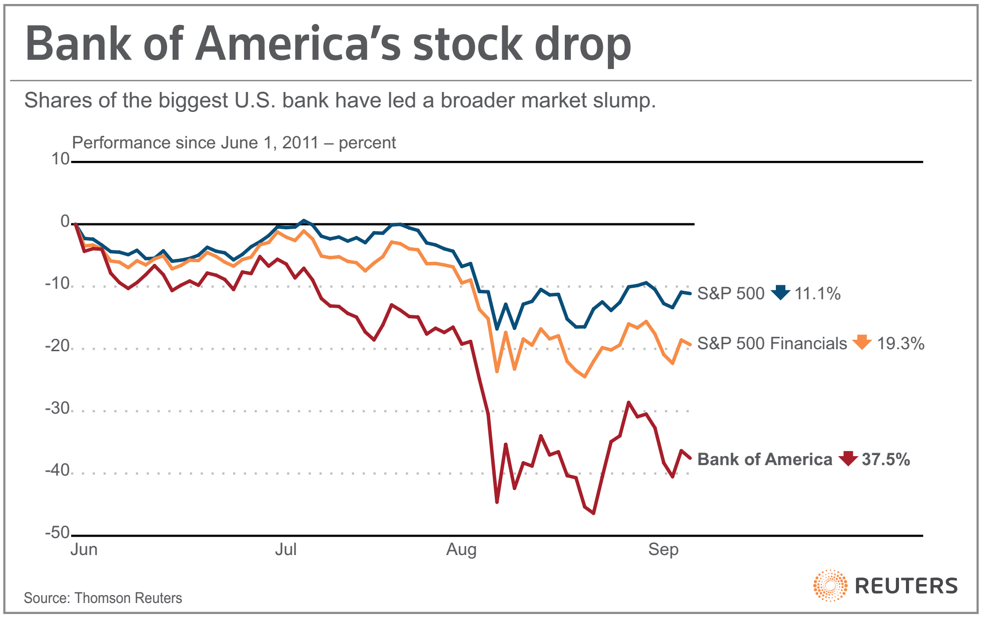
Reuters graphic/Van Tsui 08/09/2011



Reuters graphic/Stephen Culp 08/09/11

Much of the search for a radical solution stems from an ongoing debate on Wall Street about whether the bank can earn enough money over time to pay out claims and add money to its legal reserves if necessary.

Most of the bulls who believe Bank of America can earn its way out of its legal quagmire freely admit that the bank's stock is not likely to do much the next several years. Says Hempton of Bronte Capital: "I own a zombie bank."

Under a relatively conservative long-term banking industry growth rate of 3.3 percent, Bank of America could earn about $50 billion in pre-tax profits from 2012 through 2016. That's about equal to the amount most analysts peg the bank's long-term mortgage legal liability at, if it fares poorly in litigation.

Banking analyst Charles Peabody, a partner with Portales Partners, says the strategy at Bank of America is to shed assets and reduce expenses, and he thinks it can work. "I understand the game plan, and if time is given, they can get through this without raising equity."

The more bearish investors, by contrast, point out that another recession could throw a big monkey wrench into those profit projections. And predicting legal liability is notoriously difficult. In fact, analysts like

Whalen say Bank of America could find itself having to pay as much as $100 billion in damages to mortgage bond investors and homeowners.

Skeptics also point out that in the coming years, Bank of America will need to boost capital by $50 billion in order to comply with new international banking regulations designed to make sure banks are not taking on too much risk.

And next year, Bank of America will need to refinance at least $40 billion in corporate debt that is coming due. In a worst case scenario, the bank has more than $400 billion in liquid assets to pay off any maturing debt.

It's a lot of capital raising and skeptics worry that could hamper Bank of America's ability to generate new commercial and residential loans for the next several years. That's one reason people like Black, who want to break Bank of America apart, say something needs to be done to change the narrative because it's not healthy for one of the nation's biggest banks to exist in stasis for years to come.

"If you leave your major banks slowly twisting in the wind in this pathetic zombie condition, they are not going to be effective institutions," says Black.

In the case of Countrywide, Black says the damage was done to Bank of America the moment that Kenneth Lewis, the bank's former chief executive officer, pulled the trigger on the deal in early 2008. The Countrywide acquisition was a "pure ego play" for Lewis, who stepped down in December 2009 and was replaced by Moynihan.

In retrospect, if Countrywide had not been acquired and was ultimately taken over by the federal government, it would have been easier for all sides to begin working out deals with financially-strapped borrowers to reduce the principal owed on mortgages and home equity loans. Black says it's still not too late to do meaningful home loan modifications, but that's only going to happen in the context of a "bad bank" overseen by an FDIC receiver.

SHUT OUT: The Treasury Department says Bank of America remains "in need of substantial improvement" when it comes to servicing mortgages and agreeing to permanent loan modifications. **REUTERS/LUCY NICHOLSON**

The latest report by the Treasury Department gave low marks to Bank of America and JPMorgan Chase & Co in working to strike deals with struggling homeowners. In a Sept. 1 statement, the Treasury Department said both Bank of America and JPMorgan "remain in need of substantial improvement" when it comes to servicing mortgages and agreeing to permanent loan modifications.

Homeowner advocates say in any kind of overarching settlement - whether it be an asbestos-style trust, a bad bank, or the sale of litigation warrants - borrowers should have a voice as well. A group of them represented by Mississippi attorney Don Barrett has filed an objection to a proposed $8.5 billion settlement that Bank of America reached this summer with some of the nation's biggest bond investors, including BlackRock, Pacific Investment Management Co. and TCW.

Barrett says homeowners object to the settlement because the terms of the deal would make it even harder to negotiate a loan modification in the future. He cites a recent report prepared by National Consumer Law Center, which concludes that the settlement agreement "will speed up foreclosures, perpetuate existing servicing abuses in the system and undermine federal programs designed to stabilize the housing market."

The Center, which prepared the report at Barrett's request, says that in negotiating the deal with big mortgage-backed bond investors, little concern was paid to the interest of the homeowners, who took out the loans that were later bundled into bonds.

"There has got to be a solution where the borrowers' interests are taken into account. We are the third leg of the stool," says Barrett. "The current way of doing things is broken. And if it isn't fixed, it is going to take Bank of America down."

(Additional reporting by Sam Forgione, Ben Berkowitz and Michael Tarsala; editing by Michael Williams and Claudia Parsons)

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