

WEEKLY MARKET MONITOR

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CAN BANKERS BANK?

The credit crisis that began last summer has turned into a generalized credit crunch. This has the potential to inflict serious harm on an already weak economy; an economy which is probably in recession. Banks and other financial institutions have incurred losses that already exceed \$100 billion. This figure will certainly be revised upward and will ultimately become a multiple of the current amount. These losses erode and diminish the capital banks are required to have in order to lend and do other business with their customers in the U.S. and around the world. This week we'll examine the implications of banks' weakened capital:

- Why are banks reporting such large losses?
- Will banks continue to report losses?
- Can banks continue to fulfill their traditional economic role?



WHY ARE BANKS REPORTING SUCH LARGE LOSSES?

Most large banks in the U.S. and Europe, as well as a variety of other leading financial institutions such as investment banks and insurance companies have reported large, multibillion dollar losses since the onset of the credit crisis. This may strike some seasoned observers and market participants as odd, since many of the reported losses can be traced back to a foreseeable downturn in the housing market. This financial crisis, like others in the past, demonstrates that financial institutions, regulators and investors sometimes fail to anticipate growing weaknesses and recognize them only after they have turned into severe disabilities.

In a report issued in early March, regulators from the U.S., U.K., France, Germany and Switzerland wrote about the firms' exposure to housing related assets that "... some firms made strategic decisions to retain large exposures to super senior tranches of collateralized debt obligations that far exceeded the firms' understanding of the risks inherent in such instruments, and failed to take appropriate steps to control or mitigate those risks. Such firms have taken major losses on these holdings, with substantial implications for their earnings performance and capital positions."

We can translate the above statement as follows: Some firms were still long the housing market many months after the housing market began to deteriorate. These firms also did not conduct adequate due diligence on the complex structured securities they were holding on and off balance sheet, looking to ratings agencies for guidance that turned out to be of no value. Finally, risk management practices at many institutions were revealed as lacking. In sum, the report is a severe indictment of the performance of supposedly sophisticated institutions during a period of market stress.

Perhaps an unexpected outcome of the current crisis is that as a result of these large reported losses, many banks and other institutions have been compelled to go hat in hand to investors such as sovereign wealth funds (SWFs) in the Middle East and Asia in order to raise capital. These SWFs now own significant equity stakes in many large institutions in the U.S. and Europe. Hence an enduring outcome of the credit crisis will be a shift in the ownership of the financial sector in the direction of the Middle East and Asia.

The first stage of the crisis was the announcement of large losses and write-downs in the values of assets held on balance sheets. The second stage of the crisis is now beginning. This stage will be characterized by — among other things — insolvency and sale at distressed prices of troubled institutions. This stage has begun with a number of widely publicized hedge fund insolvencies on both sides of the Atlantic and the first demise of a major global financial institution (Bear Stearns). It is probable that this will not be the first major institution to fail. It is also probable — to the point of near certainty — that additional hedge fund failures will be recorded.

As the crisis becomes one of solvency, as well as liquidity, the problems facing the global financial system deepen. A solvency crisis is much harder for policymakers — especially the monetary authorities — to deal with. In particular, the Federal Reserve faces the contradictory challenge of providing adequate liquidity and promoting the stable functioning of the financial system, while not encouraging market participants to act in ways that may be destructive to the system as a whole.

In addition, the banks' ability to lend has been reduced. As banks have taken write-downs, their capital has been eroded accordingly. Since banks are required to maintain minimum levels of capital in proportion to their assets, less capital eventually — and sometimes suddenly — forces banks to reduce the total assets held on their balance sheets. This in turn translates into reduced lending to their clients.

In an environment of heightened risk aversion, banks and other financial institutions tend to reduce their exposures to the most risky customers. Hence, lending facilities and other exposures (e.g. derivatives exposures) to clients such as, highly leveraged hedge funds, are being systematically reduced, resulting in a progressive deleveraging (i.e. lower borrowing) of the financial system. This deleveraging will not stop with hedge funds, however. Banks and other financial institutions will continue to reduce lending and other exposures to a wide variety of clients. It is likely that all sectors of the economy, including the nonfinancial corporate sector and the household sector, will be affected as the credit crisis continues to propagate.

The credit crunch is rapidly becoming the most severe shock to the U.S. and global financial system in decades. As the crunch continues, the price and availability of credit will rise. The first stage of the crisis was the liquidity shock that began last summer. The second phase of the crisis is the solvency shock, characterized by the weakening and even failure of some financial institutions, as well as deleveraging. We have entered this phase. It is quite possible that the crisis will enter a third phase, characterized by a generalized reduction in credit to the nonfinancial corporate sector and to households. This will in turn have a measurable and negative impact on the real economy, both deepening and lengthening the current slump.

WHAT STEPS COULD MITIGATE, IF NOT PREVENT, SOME OF THESE EFFECTS?

One is the Fed's current actions to provide liquidity to the larger financial system, including increased lending, a lower target Federal Funds rate and the knowledge that the Fed is prepared to take extraordinary actions to ward off systemic crises. Another would be for liquidity providers (e.g. financial institutions with solid balance sheets), to step in and purchase assets and even entire financial institutions. None of these individual actions will end the crisis but taken together they can certainly help over time.

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