FAILURE SHOULD HAVE BEEN AN OPTION

by Steve Brown

It was a couple of years ago when, right before an end of the year soccer party, one of our daughters was clearing a space for her new trophy. It was then that we had to break the news to her that for the first time in her life, she wasn't going to receive a trophy for just playing, as her team didn't finish in the top 3. She cried that night, but 2 weeks later she was outside after dark practicing her jump shot for the upcoming basketball league because she "needs to earn a trophy." To learn how to win, you must know failure. Where some schools don't even have honor rolls because it offends lesser performers, we have come to support mediocrity. In addition, to coddling our kids, America coddles its financial markets too much as well.

On Sunday, under the guidance of the Treasury, OFHEO (now FHFA) placed FNMA and FHLMC under conservatorship - effectively nationalizing these firms. The move was an effort to protect safety and soundness, secure capital and ensure orderly markets. It should be quickly noted that under a conservatorship, the GSEs will not be liquidated. In the short run, both will modestly increase their MBS portfolios through the end of 2009 (in order to promote stability in the mortgage market) and will then gradually reduce the size of their respective portfolios by 10%, largely through run-off, until systemic risk is reduced to a more manageable level.

The other major point is that the Treasury will inject up to $100B of cash as preferred equity (senior to the current preferreds) to shore up capital and reserves (this move will effectively collapse most of the common equity). On the debt side, a new credit facility was established, under which the Treasury will provide secured funding on an as needed basis to all GSEs (including the FHLBs). Loans will be for short-term durations (around a month).

So what does one of the biggest announcements in the history of the financial markets mean for banks? For starters, the fact that the GSEs will continue their mortgage operations will keep markets liquid and stable. The credit profile of FNMA and FHLMC go from quasi-gov't to basically sovereign risk. Since the U.S has little experience in publicly traded national companies, it is confusing where this spread tightening will end, but it is reasonable to assume that because of the structure and the uncertainty, the GSE's will not trade on top of Treasury debt. That said, this will cause one of the greatest spread tightenings in history. After the market opened this morning, Agency MBS and senior debentures tightened by 30 to 40bps, making them the best performing asset class for banks this year. Debt issuance for these GSEs have been halted (but expected to resume) and lower supply should tighten spreads even more, as debt production should be reduced. As an offshoot, look for banks to start selling in order to monetize a portion of this gain (most shouldn't, but many will), as many banks are in need of the earnings boost. For some banks, this will present an excellent opportunity to free up capital and shrink the size of their balance sheet.

On the opposite side of the coin, the GSE's preferred equity will continue to sell off, as dividends will be deferred and the warrants the Treasury Dept. will get will erode the current preferred holder's value. This will cause additional write-downs at some banks in their Other Than Temporarily Impaired accounting. Banks are among the biggest holders of FNMA and FHLMC preferred stock and in some cases, it comprises more than 10% of Tier 1 capital. Regulators said yesterday they would work with banks that hold large exposures of FNMA and FHLMC "to develop capital-restoration plans" if necessary.

From a macro-perspective, it is unclear how much this intervention will ultimately cost taxpayers, but it will be measured in tens of billions. This is basically a transfer of risk from market participants to taxpayers. The GSE's, like Bear Stearns and others, should have been allowed to fail, been restructured and eventually returned to health. Yes, it would have dislocated the markets and put the U.S. economy into a tailspin, but we would have learned a valuable lesson about risk, leverage and the pursuit of profits. Now, we will coddle these insolvent GSEs and their stakeholders in order to protect their assets from liquidation (where a true mark-to-market would have been eye opening). The irony is, like trying to protect our kids from the despair of losing, we miss the more important lessons of risk management that we so valuably need.

BANK NEWS

Failure

Silver State Bank ($2B, NV) was closed on Friday with branches and non-brokered deposits sold to Nevada State Bank.

Ousted

The Board of WAMU fired CEO Kerry Killinger and announced it had entered into a memorandum of understanding with the OTS. The nation's largest thrift said the MOU related to risk management and compliance.

Under Pressure

The OTS has issued a C&D on Downey Financial Corp. ordering the thrift to reduce assets, provide an REO disposition plan, strengthen its executive management, decrease its risk to option ARMs and stated-income loans and maintain a minimum Tier total risk-based capital ratio of 14%.