INSANE SITUTATION

by Steve Brown

This has been the craziest week in history if you ask us and now it has culminated in another government bailout that has many different components to it.

In no particular order, the first piece of this plan gives the Treasury up to $50B and the authority to temporarily guarantee funds (for 12 months) sitting in money market mutual funds that pay a fee to participate in the program. The money for this will come from the Treasury's Exchange Stabilization Fund, which was created around the Depression in order to provide support for the U.S. dollar. This action is being taken after fears reached larger-than-life levels. This was a result of the Reserve Primary fund "breaking the buck" (the $64.8B fund held $785mm in debt issued by Lehman Brothers and was forced to write it down after the company filed for bankruptcy protection), and massive redemptions across the world in other money market mutual funds. Investors pulled a record of more than $100B out of money market mutual funds yesterday. The Federal Reserve also said it will lend money to banks at the discount rate as it moves to support redemption activity through purchases of high quality commercial paper.

The 2nd piece of the plan followed similar action yesterday taken by the UK Financial Services Authority. In it, the SEC temporarily banned short selling of 799 financial stocks. The action was taken by the SEC in order to boost investor confidence amid a growing market crisis. The ban will take effect immediately, expires on October 2, but may be extended for up to 30 days if the SEC deems it necessary.

The 3rd piece of the plan is also the largest and is still being formulated in Congress (it will probably go all weekend). This part of the plan is designed to directly address the illiquid assets that have piled up in financial institution balance sheets. It will likely create a government facility to buy up the bad debts.

This part of the plan will take some time to close off, but at this point, it appears the facility could be funded with as much as $500B to $1T to buy private-label and government-guaranteed mortgages. Financing for the entity would come from the sale of Treasuries and the expectation would be for the facility to hold any purchased securities until maturity. The other part of the plan, which would involve buying FNMA and FHLMC mortgages, would be expanded and buying will begin immediately.

Key aspects of this program that are yet to be worked out include: what price the new entity would pay for such securities, who could sell such securities to it, whether there would be a separate $400B pool at the FDIC to insure investors in money-market funds and other critical factors.

The good thing about this RTC-like 3rd component of the plan is that it would allow banks to get rid of bad debt once and for all. While losses would be expected, once the debt was transferred, the companies could go back to normalized activity. That would be helpful over the longer-term, as it would also likely improve bank willingness to lend, stabilize financial sector equity markets and provide a more comprehensive solution to this mess.

While nothing in this package seems to be directly focused on helping community banks, there could be some benefits. No matter how the program eventually ends up, it should help bring a bottom to the housing market sooner than originally predicted. That will help restart the flow of funding and should begin the process to clear the overhang of unsold homes. It should help community banks with construction exposure at a minimum, because it will speed the velocity of home sales. On the funding side, things should also get a bit easier. People don't like having their money whipsawed around, so despite the government guarantee of money market mutual funds for the next 12 months, the safety of community bank deposits will bring an influx (albeit smaller) of flows as people reallocate their risk profile. That should take some heat off extraordinarily high funding costs over time as money once again flows back into the banking sector.

In short, while we aren't big believers in government solutions to financial problems, the one-off saves were making us dizzy and fear levels were reaching the stratosphere. This will help calm things down and if it is done properly, should clear the path for a quicker return to normalcy. Let's just hope Bernanke and Paulson can keep control over Congress as a deal gets hammered out this weekend.

BANK NEWS

Fed Discount Window

Borrowings hit an all-time high of $121.3B on Weds. $33.4B went to commercial banks, also a record.

Washington Mutual

Stories are surfacing that 6 potential buyers are currently looking at the books of WAMU. Names picked up by the press include JPMorgan, Citigroup, Bank of America, Wells Fargo and Spain's largest bank, Banco Santander.

Sensitive Information

A new study finds 65% of employees leave work with a PDA or laptop device holding sensitive customer information from time to time.

Web Site Traffic

A new study finds the same 6% of users account for 50% of all click-through traffic that happens on the average web site. Banks trying to attract new customers or target existing ones should be aware of this fact.