HERE IS WHAT WE KNOW NOW

by Steve Brown

Two weeks ago we wrote about the possibility of the Large Hadron Collider producing a small black hole with the power to suck things like Senator Charles Schumer into oblivion. Maybe it was an errant photon or maybe coincidence, but since its first test, the financial markets have been a wreck. On Friday, the collider broke, so we hope things return to normal this week.

At last we left you on Friday, we learned that the free markets weren't really "free" and the Gov't was stepping up with an RTC-like entity that would purchase assets and aid in the orderly disposition. While we thought the FNMA/FHLMC conservatorship was "the mother of all bailouts," the proposed $700B Paulson plan makes the GSE attempt look subatomic. The latest plan raises the ceiling on national debt with the authorization to spend an amount basically equal to the combined budgets of the Dept. of Defense, Education and Health & Human Services. This is a huge sum and one that could even become more expensive in coming days, as a myriad of legislators attempt to tack on provisions such as the suspension of housing foreclosures.

The most important new development for banks is the change that only money market mutual fund balances that existed prior to the close of business on Friday will be guaranteed for a period of one year. For a while on Sat. morning, we worried that the Treasury was about to make the largest mistake in history, by allowing money market mutual funds to take interest rate and corporate risk, pay a high return and be guaranteed by the Gov't. That would have spelled disaster for bank funding, but lucky leaders came to their senses by Sunday morning. Now, only fund balances present as of the close of last Friday will be guaranteed. This will prevent further liquidation of assets into a thinly traded market, thus protecting more funds from "breaking the buck."

In terms of the asset repurchase entity, the latest draft proposal allows banks, thrifts, credit unions, broker-dealers and insurance companies to sell assets originated on or before Sept. 17th into a separate corporation. Non-U.S. entities would also be eligible for participation, with the approval of the Fed. Noticeably absent are hedge funds (the next crisis), municipalities and pension funds (particularly the already under-funded kind). Assets allowable for sale include home loans, commercial loans, mortgage-backed securities and the newly added catch-all, ``other assets, as deemed necessary to effectively stabilize financial markets." So while the facility was originally meant to stabilize real estate related assets, the door has been left open for all types of asset classes. The Treasury has also requested the power to issue regulations, hire asset managers and award contracts to private firms that can assist in asset disposition and management. In fact, speaking of power, the current proposal contains the very imperialistic sounding sentence that reads, "Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency." The provision was included in order to prevent parties from litigating and slowing things down. While some legal protection is important, Paulson basically just named himself King. Luckily, the term of these provisions mostly phase out after 2Ys from the date of enactment.

This facility would have the ability to provide liquidity to the market, as it purchases troubled assets at some semblance of a market price via reverse auction. Yes, from what we know now, banks would still have to take the write-down, but many are calling for additional relief by wanting any losses to be written off over a longer period of time than current GAAP permits. Once this facility has the assets, it would then look to sell them in the open market via auction. When we say "some semblance of a market price," we mean that, because of the structure and intent of the facility. Banks will most likely gain an above average price for sold assets, since the existence of this very facility will increase the value of any asset sold into it. This is ironic, but it basically amounts to an injection of capital into banks and thus economically encourages sales into the facility. While it is too early to tell, as of now, we are encouraging our client banks to prepare to sell any distressed assets, in order to take advantage of this transfer of wealth from taxpayer to financial institution shareholder. We also recommend banks do this quick, before the Hadron Collider starts up again.

BANK NEWS

Bank Failure #12

Ameribank ($115mm, WVA) was closed on Friday by the FDIC after the bank ran into trouble related to its construction loan portfolio. The bank was "critically undercapitalized" and was under an enforcement action. The bank's 5 branches in WVA were assumed by Pioneer Community Bank ($66mm, WVA) for a 2% premium on deposits and its 3 OH branches were acquired by Citizens Savings Bank ($426mm, OH) for a 1.14% premium.

Now Banks

Goldman Sachs and Morgan Stanley have been allowed by the FRB to become banks, scrapping the Wall Street investment banking model as they become traditional bank holding companies.

Morgan Stanley

Mitsubishi UFJ, Japan's largest bank, said it will buy up to 20% of Morgan Stanley.