HINDSIGHT AND THE FRB

by Steve Brown

An interesting study we dug up found that only 10% of people use the function keys at the top of the computer keyboard, so don't be surprised if they are eventually phased-out (both the users and the function keys). Anyway, given space is at a premium on laptops, we venture to say that if the non-use-of-function-key information were available when the first computers rolled off the assembly lines, we may never have experienced the function key at all. Hindsight is perfect, which is why we were also intrigued by FRB Chair Bernanke's speech on Friday at the Annual Economic Symposium. In that speech, he reflected on the crisis and the ensuing global response. Here are some of the salient points.

The current recession began in Aug. 2007, was officially labeled in Dec. 2007 (by the NBER) and intensified massively in Sep. and Oct. 2008. Looking back, consider that in Sep. 2008, the Fed Funds target rate was 2.00% and the feeling was that lower rates would not be needed (based on forward Fed Funds futures at that time). The collapse of FNMA, FHLMC, Lehman, AIG and others changed all that and the result was a good old fashioned financial panic.

In his speech, Bernanke indicates the FRB worked with other government agencies to try and find a buyer for Lehman when it collapsed, but were unsuccessful. He noted that the FRB can only make loans on a secured basis and since Lehman's "available collateral fell well short of the amount needed to secure a FRB loan of sufficient size to meet its funding needs," the option was not available. Basically, Lehman was nearly out of collateral and "the government as a whole lacked appropriate resolution authority or the ability to inject capital." As a result, these factors ultimately led to the demise of Lehman.

Also in the speech, Bernanke addresses the rescue of AIG. Here he indicates that "the Federal Reserve judged that the company's financial and business assets were adequate to secure an $85B line of credit, (which was) enough to avert its imminent failure." Given the breadth of reach of AIG into other financial entities and the risk of systemic issues, AIG's rescue was considered one stabilizing factor during the crisis.

In the US, the FRB and other Gov't agencies responded by establishing liquidity facilities focused on "restoring basic functioning in critical markets." These included programs designed to stabilize money market mutual funds, commercial paper, injecting capital into banks, improving availability of credit for households and businesses, expanding deposit insurance coverage (20 other countries also did that), offering FDIC guaranteed debt issuance for banks and bank holding companies and pouring a flood of liquidity into the system.

After talking about the past, Bernanke deftly moved to a view of the future. In it he indicated that while progress has been "noteworthy," "critical challenges remain" and "financial institutions face significant additional losses." He also gave perspective on future policies and regulatory reforms, stating that "the experience has underscored that liquidity risk management is as essential as capital adequacy and credit and market risk management" and that a "system-wide or macro-prudential approach to regulation is needed."

No matter how you feel about the current situation, we agree with Bernanke's assessment that "without these speedy and forceful actions, last October's panic would likely have continued to intensify, more major financial firms would have failed, and the entire global financial system would have been at serious risk." The power of hindsight is strong and certainly mistakes may have been made. That said, given the gravity of the situation, we applaud the FRB, Treasury and yes, even some in Congress, for the action taken to save the financial system as we know it.

BANK NEWS

4 More Bank Closures (81 YTD)

In another rough Friday, the FDIC closed 4 banks, bringing the yearly total to 81. Closures included: [1] Guaranty Bank ($13B, TX), which was bought by Spain's 2nd largest bank, Banco Bilbao Vizcaya Argentaria SA (also parent company of Compass Bank ($62B, AL)). This marked the 1st purchase by a foreign bank; the FDIC will share losses on $11B of assets; it was the 12th largest bank failure in US history and it is expected to cost the deposit insurance fund $3B (2nd largest failure of the year); [2] CapitalSouth Bank ($617mm, AL) was bought by IBERIABANK ($4B, LA). The FDIC will share losses on $499mm of assets; [3] First Coweta ($167mm, GA) was purchased by United Bank (GA) and had a 2Q Texas Ratio of 460%. The FDIC will share losses on $124mm of assets and this marks the 18th bank failure in GA; [4] ebank ($143mm, GA) was bought by Stearns Bank (MN) and had a 2Q Texas Ratio of 182%. The FDIC will share losses on $111mm of assets.

Clarification

Our article on Friday about the FRB Discount Window should have said that margins in the tables for both individually deposited and group-deposited loans are applied to a fair market value estimate that is not published.