

The road to hell is paved with good intentions

By Max King, Eden Investment Strategist

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Efforts by the authorities to steer a course through the credit crisis have been dogged by the unintended consequences of their actions. Sensibly, they have wanted to build confidence, restore liquidity, protect savers and borrowers from loss and foreclosure without bailing out shareholders, rewarding management or encouraging reckless risk-taking in the future. The consequence has been a series of positive steps but also some unfortunate unintended consequences.

The nationalisation (or “conservatorship”) of Fannie Mae and Freddie Mac was intended to stabilise the US mortgage market by bringing down rates. In this it succeeded as mortgage lenders could, once again, rely on the guarantee provided in the secondary market, and so mortgage rates fell by 50 – 100 basis points. However, nationalisation created a default in the credit derivatives market, which will take time to sort out, result in unquantifiable losses and undermine confidence in all outstanding credit insurance. More importantly, the Federal Reserve had strong-armed investors, mostly US regional banks, to subscribe for \$20 billion in preferred shares. Wiping these out in order not to bail out investors was hardly a way to encourage the private sector to lend a hand in future bail-outs.

The bail-out of AIG had a similar effect. AIG is being lent up to \$85 billion dollar at usurious rates: 8.5% over Libor with the Federal Reserve grabbing 80% of the equity at nominal cost. Again, investors were encouraged to walk away from troubled financial institutions.

Allowing Lehman to go bankrupt was justifiable, but there were consequences. With around \$140 billion of liabilities, chaos in financial markets ensued. Most of these liabilities are matched by assets, but times of crisis are not times when creditors can afford to wait patiently and trustingly to get their money back. Money market funds (the US equivalent of deposit accounts) had to take provisions on Lehman paper and the value of some slipped below par. To prevent an investor stampede out of money funds, a key provider of banking liquidity, the Federal Reserve has had to provide \$100bn of guarantees and an asset-backed commercial paper buy-back programme.

In the UK, the nationalisation of Bradford & Bingley is hailed as ingeniously saving the taxpayer because, under the Financial Services Compensation Scheme, any loss in liquidating the loan book and interest on the £20 billion loan can be reclaimed from other banks. So, prudent banks will be required to pay for the imprudent lending of others, over which they had no control, and for the inevitable incompetence of bureaucrats in getting the best price for the assets. The forced sale of HBOS to Lloyds avoids a government bail-out but hands Lloyds a dominant market position which is hardly in the interest of competition.

The omens for the recently announced \$700 billion Troubled Assets Relief Program (TARP) suggest a similarly mixed outcome. In principle, the plan is a good one. Separating bad assets from good assets so that the former does not infect the latter or prevent the continued provision of credit is a tried and tested formula. Government backed schemes were used successfully in Japan, Sweden and the US (the Resolution Trust Corporation in the early 1990s), and the Equitas scheme for Lloyds succeeded without government backing. The lessons from these examples were that speed is very important and government support (in the case of banking bail-outs) essential.

However, predictions of imminent disaster if such a scheme is not implemented immediately are pure hyperbole. Gordon Brown’s support for the plan “whatever the details” is utterly idiotic – the details are absolutely key. The most important detail is the price paid for “troubled assets.” If it is too much, the US taxpayer is bailing out bank shareholders and management, if too little, TARP will be ineffective, perhaps even undermining confidence in asset values further. Proper supervision by Congress, rather than handing a blank cheque to the Treasury Secretary, is hardly unreasonable

and concerns that the programme should not be put in the hands of investment bankers is fully justified.

As Bill Gross, CIO of Pimco, set out in the Washington Post on September 24th ("How Main Street will profit"), a scheme which achieves the objective of restoring confidence without an ultimate net cost to the taxpayer is perfectly feasible. This is shown by precedents: the Swedish bail-out of the banking system in the 1990s initially cost 4% of GDP, but all the costs were later recouped on the sale of assets. RTC's take-over of nearly 800 Savings & Loans Associations cost up to \$500 billion, but the net cost to the taxpayer ended up as \$124 billion – and was only that high because the S&Ls had such thin equity cushions.

The lessons from precedents are firstly that speed is important: delay increases the ultimate cost. For example, RTC was formed in Spring 1989 but only really got going in 1990. Secondly, initial estimates of the cost are usually too low (think \$1 trillion rather than \$700 billion) but the net cost can end up as zero, and should be a lot less than the gross number. Thirdly, bank bail-outs are a necessary but not sufficient condition for economic recovery: the rescue of the Japanese banks in the late 1990s was a success, but the economy continued to stagnate as a result of misguided government infrastructure spending, insufficient market reforms and the chronic disinterest of Japanese companies in capital markets. Fourthly, external events can get in the way: the Iraqi invasion of Kuwait in August 1990 interrupted the RTC bail-out and caused a recession anyway.

Finally, markets respond very positively to well crafted and well-timed programmes, subject to 3 and 4 above. RTC was relatively early in the cycle and the recovery in the Japanese market in 1998-9 was later swamped by the subsequent global bear market. Markets certainly do not wait until all the problems are resolved and the taxpayers have got their money back. With valuations at rock bottom, the economic slowdown now well underway and profitability in most of the market bearing up well, markets should start to recover very quickly. Investors are understandably impatient for results, but the key to recovery is not the actions of government, but the rebuilding of confidence. That will not happen overnight.

In the very short term, confidence is not helped by dire warnings of The End of the World (deliberate capitals) if the proposals are not rushed through. We will never find out whether this was really true, but with depositors fully protected from financial loss in all markets and borrowers, especially mortgage borrowers, protected from the dramatic increase in rates which the banking market, left to its own devices, would impose, it is not easy to see how the absence of TARP would inevitably spell disaster. The freezing of credit markets has had dire consequences on banks which rely on them for finance, but not on those who would normally lend in those markets. Most of the former have gone already while the latter continue to lend, on more stringent terms, to good customers.

There are plenty of complaints that TARP doesn't go far enough, that similar schemes are needed elsewhere and that what is also needed is a recapitalisation of the banking system. This is undeniably true: banks simply don't have the capital to finance credit expansion even if confidence is restored. Without credit expansion, economies, especially in the UK and US, will continue to be sluggish at best. The problem with this argument is two-fold. Firstly, a speedy resumption of credit expansion is the last thing that the US and UK economies need. It would bring another unsustainable boom, another subsequent bust, inflation and collapsing currencies. The long-term health of both economies depends on less reliance on credit and more focus on production of goods and value-added services. Growth needs to be slower for a few years, but it will be sustainable and of better quality. If banks are short of capital, they will at least find it easier to resist the temptation to be reckless.

Secondly, the authorities are not well placed to allocate capital to banks. This would inevitably mean putting money into under-capitalised banks, not well-capitalised ones. In other words, it means throwing good (taxpayers) money after bad and propping up failure. The best strategy is to leave it to the market. The share prices of those who have ridden out the crisis without help from the government should soon recover, and they would then be able to raise capital for expansion from the market. With less competition, higher margins and increasingly good quality opportunities, they should have little difficulty attracting investors.

The risks of TARP and the other measures to “bail-out” the banks and restore confidence are different to those in the popular imagination. Increased regulation could make the problems worse, not better. Rules-based regulation has failed to control risk, but there are encouraging signs of the authorities moving in the right direction; towards focusing on the spirit of the rules rather than more stringent formalisation which would ham-string the responsible and be evaded by the irresponsible. The attempt to make the good banks pay for the bad, through the FSCS in the UK and through one of the provisions of TARP in the US, threatens to result in the infection of the good banks with the bad.

Finally, public opinion and the authorities have forgotten who were the real beneficiaries of the credit bubble. It was not the Wall Street or City financiers, certainly not those whose bonuses were paid in shares. It was all those who were able to borrow excessive amounts of money at low rates and governments who received a rapidly rising stream of tax revenue with which to finance wasteful expenditure. If reckless borrowers and governments are not brought to account, and the lesson of moral hazard is inflicted only on investors and managements, then boom and bust will keep on recurring.

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