Too Big To Fail

Bear Stearns was too big to fail. Fannie and Freddie are too big to fail. The 17 largest investment banks are too big to fail. Are Ford, GM and Chrysler too big to fail? Is the airline industry too big to fail? The question of whether a business is too big to fail is again being highly scrutinized as US financial companies are lining up in Washington for bailouts and the Fed and US Treasury are scrambling for solutions to prop up markets weighed down by heavy investor pessimism. After a strong start to the month, US equity markets made a sudden U-turn after the failure of IndyMac. The ensuing speculation over the potential failure of Fannie Mae and Freddie Mac sent markets into a panic. Regulators took a two-pronged approach to stopping the slide by stating their support for Fannie Mae and Freddie Mac and by cracking down on short sellers of financial company shares. Both moves reek of desperation and contributed to the volatility that lead to double digit moves in the DJIA every day during the last week of July. Despite the volatility, the major equity indices finished the month +0.43% for the DJIA, -0.83% for the S&P and +1.42% for NASDAQ. Small Caps outperformed during the month with the Russell 2000 finishing the month +3.70%.

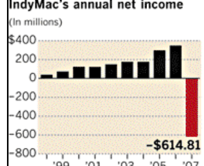
The term "Too Big To Fail" ("TBTF") is frequently used in banking regulation to characterize the largest and most powerful banks, those that could pose a systemic risk to markets if they failed. While the question of who is TBTF has been asked many times before, the answer is never quite clear as was the case with the recent failure of IndyMac Bank in California. TBTF was highly scrutinized throughout the 1980's as a number of banks were assisted by both the Federal Reserve and the US Treasury, most notable amongst them was Continental Illinois National Bank, the largest US bank failure in history.

Coming into the 1980's, Continental was one of the most highly rated banks amongst analysts, praised for its aggressive growth in commercial lending (often at rates below prime) and superior management. The party stopped in 1982 when Penn Square Bank in Oklahoma failed. Continental had purchased over $1 billion in participations from Penn Square to gain exposure to the booming oil and gas exploration business, but as oil plunged from the highs of the late 70's, Penn and Continental took heavy losses. Continental's situation was further complicated by the massive exposure it had to emerging market debt and the losses that were set off by Mexico's default in August of 1982. By 1984, the bank's nonperforming loans increased from $400 million to a record $2.3 billion, with over half the increase coming from Latin American debt. By this time, the writing was on the wall. As investors bailed and depositors withdrew assets, the bank was still calling stories of its bankruptcy "totally preposterous". Bank regulators were not quite as calm and as the situation deteriorated further, the risk of the crisis affecting the entire banking system prompted action from the FDIC and the Federal Reserve. Belatedly, the regulators cobbled together an assistance package to keep Continental functioning long enough to stabilize the banking system. However, the most controversial move by regulators was the promise by the FDIC to protect all of Continental's depositors and other creditors, regardless of the $100,000 limit on deposit insurance.

Let's fast forward to the failure of IndyMac Bank in California this past month, the second largest bank failure in US history. In recent years, IndyMac had been a leader in Alt-A mortgages (the risk profile for Alt-A mortgages is between sub-prime and prime and typically have higher loan to value ratios, debt to income ratios and/or inadequate documentation of the borrower's income), posting strong profits in 2006 when its stock peaked at $50 giving the bank a valuation of $3.5 billion. However, as mortgage defaults accelerated in 2007, the bank lost over $600 million for the year and another $184 million in the first quarter of 2008.

IndyMac joins an infamous list

IndyMac's annual net income



Largest bank failures before IndyMac

Institution	Location	Failure year	Deposits (in billions)	Assets (in billions)
Continental Illinois	Chicago	1984	$28.6	$40.0
American Savings & Loan	Stockton	1988	15.4	30.2
First Republic Bank	Dallas	1988	7.7	17.1
Bank of New England	Boston	1991	9.4	13.4
Gibraltar Savings	Simi Valley	1989	7.6	13.4
HomeFed Bank	San Diego	1992	8.9	12.2

Source: Bloomberg News

The accelerated losses prompted Senator Charles Schumer of New York to send letters this past June to the FDIC and the OTS (Office of Thrift Supervision) addressing the serious problems IndyMac's loan portfolio was facing. The warning prompted a run on the bank with depositors withdrawing over $1 billion in the two weeks before its failure. The FDIC has since taken over IndyMac and expects the takeover to cost between

$4 and $8 billion. In stark contrast to Continental, the FDIC is protecting depositors up to the $100,000 limit only.

The reality of the current banking crisis is very different than the crises of past decades, specifically the 1980's when over 2,000 banks failed, but the underlying current of events that lead to these crises is remarkably analogous. Specifically, it is the repeated overexposure to illiquid and/or risky assets and weak regulation compounded by the inability of regulators and elected officials to identify crises in a timely manner. Both the Continental and IndyMac failures could have been avoided if regulators had done their job and identified the risks of those banks and been more proactive in creating solutions. For both bankers and regulators, history is clearly not a strong subject as both the Federal Reserve and the US Treasury once again have proven themselves slow to react. More importantly, the principle of TBTF has created a moral hazard for institutions like Fannie Mae and Freddie Mac, which took greater risks with the knowledge that a government bailout was highly likely.

While there is a history of bank failures we can study, unfortunately, there are no blueprints for how to bail out Fannie Mae and Freddie Mac. It is, however, extremely disconcerting to see regulators take until now to address the inevitable problems of Fannie and Freddie. The warning signs of the current crisis were well over a year ago, but it has taken until now to appreciate the risks the housing crisis poses to the two entities that together have mortgage exposure of over $5 trillion, representing half of the entire US mortgage market. Both groups have been allowed to operate with minimum capital and were allowed to stray from their core purpose. At the end of 2007, Fannie and Freddie had core capital of $83.2 billion supporting around $5.2 trillion of debt and guarantees, a leverage ratio of 65 to 1. There is no way a private bank would be allowed to have such a levered balance sheet. In addition, both companies are counterparties to trillions of dollars worth of derivative transactions that have been used to hedge their portfolios. Fannie Mae posted a loss of $2.2 billion in the first quarter alone, exceeding its loses for all of 2007. Both companies had credit related write downs of more than $5 billion in 2007 alone. Despite these losses, politicians are still counting on Fannie and Freddie more than ever to keep the mortgage market functioning.

Fannie Mae and Freddie Mac were created in 1938 and 1970, respectively, to help make home ownership more affordable by providing liquidity to the mortgage market through the purchase of mortgages from banks, thereby freeing those banks to continue making loans. These purchased loans are then repackaged as collateral for MBS (Mortgage Backed Securities) that are then sold off primarily to institutional investors. Both Fannie and Freddie guarantee payments on their MBS and are responsible for making up any shortfalls in payments from the underlying mortgages. Though the companies have had very limited exposure to the sub-prime market, it is their investment in the MBS issued by other companies (and sometimes buying each other's MBS) that are now causing additional loses for the two companies. In addition, both companies have sizable exposure to the same Alt-A mortgages that led to IndyMac's demise.

At the end of 2007, Fannie had over $120 billion of exposure to outside MBS, almost six times more than it had a decade before. Although both companies state that they are not backed by the government, investors believed that the government would not let them fail, due primarily to the TBTF principle. Even the ratings agencies have sited government support as one of the reasons for the high credit ratings given to the companies. It's hard to blame them when both Fannie and Freddie can have up to five directors elected to their boards by the President of the United States himself. Currently those seats are vacant for both companies, but that possibility in itself changes the perception of the companies in the market's eyes. The stock market has called the bluff as the recent housing bill confirmed the government's guarantee by giving the Fed and the US Treasury all the power they need to keep the companies solvent. Under the new bill, the Treasury has been given the authority to use virtually any amount of capital to bail them out. To help facilitate this support, the bill raised the federal debt ceiling by $800 billion to an astounding $10.6 trillion. The Congressional Budget Office expects the cost of a bailout between now and December 2009 (when the authority of the bill lapses) to be less than $25 billion. What better way to solve the problem than by throwing more money at it.

While the government support for Fannie and Freddie was key to stopping the slide in equities, the bizarre move by the SEC to limit short interest in a number of financial companies set off a rally at mid month. As rumors were running rampant about which Wall Street bank was next to fail, it is clear those very banks lobbied hard for a brief reprieve from the short sellers that were punishing their stocks. The result of the ruling was massive short covering that sent the financial sector skyrocketing from their mid-July lows. Given the problems of Fannie, Freddie and the financial sector as a whole, it is hard to fault investors for aggressively shorting shares. The SEC is right in limiting the amount of "naked" shorting (shorting a stock without actually securing the borrow) that can be done. This is a regulation that should already have been enforced, not just for the financial companies, but for all equities. Allowing multiple investors to short the same shares is clearly harmful to markets as a whole, but applying the ruling asymmetrically may prove to be even more detrimental as it signals that banks are allowed to continue with their chicanery. The move looks even more dubious with Merrill Lynch involved in a $6.7

billion CDO sale (if you can call it that). Merrill sold the assets for 22 cents on the dollar, creating a new market price in the illiquid CDO market, but it is financing 75% of the purchase price themselves. Merrill surely must have upside in the deal should those assets have value at some point down the road, but the deal is puzzling nonetheless. When financial companies behave in such absurd ways, the markets are right to make them pay the price, and the short sellers are there to keep them honest.

The macroeconomic effects of the Fannie and Freddie bailouts are difficult to assess, but they certainly can't instill confidence in the dollar and US treasuries. The recent budget deficit was the largest ever (the cost of the Iraq War was not even included) and the US Treasury must now go out and borrow more money to solve the housing crisis. Growth has clearly slowed and sometime in 2009 when all of the GDP revisions are finalized, there is a strong likelihood those figures will confirm that the recession likely started in late 2007 or early 2008. It is unlikely that we will see anywhere near the number of bank failures that occurred during the Savings and Loan crisis, primarily due to the globalization of the financial system, but should a couple of larger banks fail, FDIC funding may come under stress, ultimately putting the government on the hook again. In the end, it is the American taxpayer that will pay the ultimate price. The federal debt is likely to balloon beyond the debt ceiling in the recent housing bill and begs the question: Can America default on its debt? As the Chinese own most of our debt, let's hope they deeply believe in the TBTF principle.