

# Interim Market Update



Central Plains Advisors, Inc. • 100 N. Broadway Ste. 130 Wichita , KS 67202 • Economic Consulting & Investment Management

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## **BANKING PROBLEMS**

**As you know, we have railed against Wall Street, money center banks, and the Federal Reserve ad nauseam, so much so that many have complained that we never say anything new. What we saw was perfectly clear, at least to us; what we didn't know was when it would become obvious enough to everyone else to finally become conventional wisdom. Now it has. The financial community in our country, as well as those overseas, is under stress not seen since the 1930's. Please read the enclosed article from *The Economist*.**

**We are not expecting Armageddon; however, it may seem like it. A lot of trouble lies ahead. Be careful with your investments. Direct obligations of the Federal Government are the place to be.**



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## Down the drain

Sep 6th 2007 | NEW YORK AND LONDON  
From The Economist print edition

Illustration by Satoshi Kambayashi



### The money markets are still blocked. Do central banks have the right tools?

“NOT only is there no God,” said Woody Allen, “but try getting a plumber on weekends.” That just about sums up the problems of today's financial markets. The plumbing is badly blocked, and nobody seems able to fix it, not even the central banks, the market's immortals.

The problem is the apparent reluctance of banks to lend to each other, particularly over three months. That problem arises, in part, from uncertainty about who will pay the bill for America's subprime-mortgage collapse. But it also results from the need for banks to protect their own balance-sheets in the face of some unexpected claims on their capital.

The result is that banks are paying much more to borrow than normal, particularly compared with governments. According to Goldman Sachs, one measure of this gap between American Treasury bills and interbank rates, nicknamed the “Ted spread”, is at a 20-year high. And like other plumbing problems, this could have severe consequences, because when banks pay more to borrow they pass the cost on to consumers and companies.

On September 5th the Bank of England got its monkey wrench out and tackled one issue, the half-percentage-point gap between overnight lending rates and its official benchmark. The Bank promised to lend more money to the market, if necessary, to bring overnight rates down.

Critics argue that the Bank has been time-wasting. The European Central Bank and the Federal Reserve made similar moves last month, and the ECB did so again on September 6th. But the Bank of England's failure to act sooner seems to be part of a general reluctance to be seen to be saving speculators from their mistakes. The Bank made it clear that it was not aiming to bring down three-month lending rates, which are the markets' most acute pressure point. A bank may be good for its money in the morning, but who knows what will have happened by December?

Perhaps central banks cannot solve the problem on their own anyway. They have offered to provide finance to any bank that needs it via mechanisms such as the discount window operated by the Federal Reserve. But banks are understandably reluctant to show any hint of desperation. Borrowing from a central bank in the middle of a liquidity crisis is rather like a schoolboy agreeing to have a sign saying “Kick me” pinned to his shirt-tails.

Even a cut in official rates, as is expected in America later this month, may not clear the blockage. The

fundamental problem is that the banks made promises that they did not expect to have to keep. These "contingent liabilities" require banks to take the strain when their clients face problems in finding funding elsewhere. Suddenly, a lot of these bills have come due at once.

According to Dealogic, more than \$380 billion of loans and bonds linked to pending leveraged buy-outs need to be shifted now that Wall Street bankers have returned from their holidays. The speed of the market deterioration has been a big part of the problem. Banks made short-term or bridge loans to private-equity buyers with a typical 30-60 day holding period. When the markets were buzzing earlier this year, they assumed nothing could go wrong in such a short time. But they were wrong, and now they face the prospect of having to keep large chunks of the debt on their own books indefinitely, marked at a loss.

How big a loss is hard to gauge. One indication is the discounted price at which leveraged loans are trading in the secondary market (see chart). Another is the tussle over the financing for the takeover of First Data, a transaction-processing company. This has already been postponed once. Banks will try to syndicate it again soon. Investors seem unwilling to pay more than 94-95% of par value for the \$14 billion of loans in the package. That would wipe out the banks' fees on the deal and leave them with further losses of 3-4%. One banker involved in the deal says its fate is still clouded in uncertainty: "We still don't know if an avalanche is going to fall on our heads."

First Data will set the tone for other deals, such as the takeovers of TXU, a utility, and Alltel, a mobile-phone firm. The main obstacle is that the First Data deal "has all the bells and whistles of the bubble era", says another banker: it is, for instance, "covenant-lite" and offers lenders little protection.

Banks would love to wriggle out of the most egregious deals, or at least get better terms. But that is proving hard. They painted themselves into a corner when the market was booming. Previously, many deals included a "material adverse change" clause that cancelled the financing if severe turbulence hit the markets. These would have been handy today, but the banks stopped insisting on them.

As if the buy-out issue was not bad enough, banks face a bigger danger elsewhere, linked to the subprime-mortgage crisis. This threat involves a series of specialist investment vehicles known as conduits and structured investment vehicles (SIVs). Conduits were mainly set up by banks as "off-balance-sheet" vehicles for themselves and their customers that allowed them to invest in slightly riskier assets. SIVs tend to be independent. Both borrowed partially (but not exclusively) in a form of short-term debt known as asset-backed commercial paper.

The investors who bought this paper are now deciding it is not worth the risk. That gives the conduits and SIVs a problem. Moody's, a rating agency, says many have found funding "either impossible or achievable only at exorbitant levels". On September 5th the agency downgraded (or placed on review) some \$14 billion-worth of bonds as a result.

Some SIVs had back-up banking facilities; some did not. But avoiding this direct liability may be of little help for the banking industry as a whole, since when SIVs cannot get funding, they are forced to sell assets. This pushes down prices and increases the chances of the banks suffering losses elsewhere.

Banks are now finding that these risks are coming racing back onto their balance-sheets. It is an ugly prospect since Tim Bond of Barclays Capital estimates that \$1.4 trillion-worth of conduits are out there. Either the banks will have to lend money directly to them, or they will end up owning a ragbag of securities—including some dreaded mortgage-linked bonds.

What seemed a clever wheeze to avoid the scrutiny of the regulators and auditors now looks foolish,



since no bank knows the exposure of any other. Worse, none knows the extent to which it will end up on the hook itself. As a result, banks are hoarding their capital rather than lending it in the money markets.

If banks have to borrow at penal rates for some time, the poison will spread. Investment banks, for instance, do not rely on consumer deposits for funding, but on borrowing from commercial banks and others. If the cost of their finance goes up, they will have either to cut the supply, or raise the cost, of finance to important investors such as hedge funds. Those hedge funds will then have to sell assets, which might give the whole system another downward lurch. Where's that plumber when you need him?