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U.S. Financial Crisis Enters New, But Perhaps Necessary Phase

Government Balks at Lehman Bailout; Focused on Stemming Turmoil

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KEY TAKEAWAYS

- **Another bout of financial turmoil rose to a boil, as rapid share price declines forced one major Wall Street firm to file for bankruptcy (Lehman Brothers) and another to sell itself (Merrill Lynch).**
- **Unlike in the case of Bear Stearns, the U.S. government declined to provide financial support for any acquisitions, representing a new phase in the current financial crisis.**
- **Drawing upon the lessons of Japan and previous banking crises, the U.S. government has started to place limits on its involvement—allowing financial institutions to fail, while at the same time broadening support to mitigate systemic impact.**
- **Under this framework, the government allows weak institutions to be bought by strong ones, with bankruptcy for insolvent firms considered a better option for the whole system than allowing bad assets to fester and impair a broad recovery in lending.**
- **The government has signaled it remains focused on averting a systemic collapse; only time will tell whether the global credit markets can right themselves without a publicly funded direct recapitalization of the financial system.**

SUMMARY OF RECENT MARKET EVENTS (as of the morning of September 15, 2008):
Rapid share price declines for some major financial firms made new actions necessary:

- **Merrill Lynch agreed to be acquired by Bank of America**
- **Lehman Brothers to file for bankruptcy after failing to find a buyer**
- **AIG and others scrambled to sell assets and shore-up balance sheets**
- **The federal government did not participate in a bail-out of Lehman Brothers**
- **The Fed expanded its emergency lending facilities**
- **Ten large banks created a $70 billion pool loan program to protect firms against near-term liquidity issues**

Lessons From The Past

Throughout the current credit crisis, the Federal Reserve and the Treasury Department have followed a blueprint that draws from many lessons learned during previous crises, including Japan's banking crisis in the 1990s and the Great Depression. Japan and the Great Depression—both traumatizing economic catastrophes that lasted more than a decade—provide plenty of examples of what policymakers should not do. For instance, in the aftermath of the 1929 stock market crash, the Fed was slow to lower interest rates and the federal government slow to provide economic stimulus to prop up flagging demand. Bank failures proliferated, the financial system teetered near collapse and the U.S. economy experienced its worst economic downturn of the past century.

The lessons of what a government should do during a financial crisis can be grouped into three general categories of activities.

- The financial crisis must be prevented from spreading in a way that threatens the entire system with collapse.
- Aggregate demand should be bolstered to mitigate the negative impact of tighter credit and de-leveraging on the rest of the economy.
- Bad assets must be disposed of quickly, so that surviving financial institutions can recapitalize and be unencumbered in future lending, which is necessary for both the economy and the financial system to get back on their feet.

Government Response So Far: Focused On Crisis and Demand

The government response to the 2007 credit crisis (including the Federal Reserve) has focused heavily on emergency measures to avert a systemic meltdown, as well as actions to prop up demand in the housing and consumer markets (see Exhibit 1, below). They include aggressive interest rate cuts and several hundred billions of dollars of credit facilities offered by the Federal Reserve, direct federal government management and support of mortgage giants Fannie Mae and Freddie Mac, and the stimulus package approved by Congress.

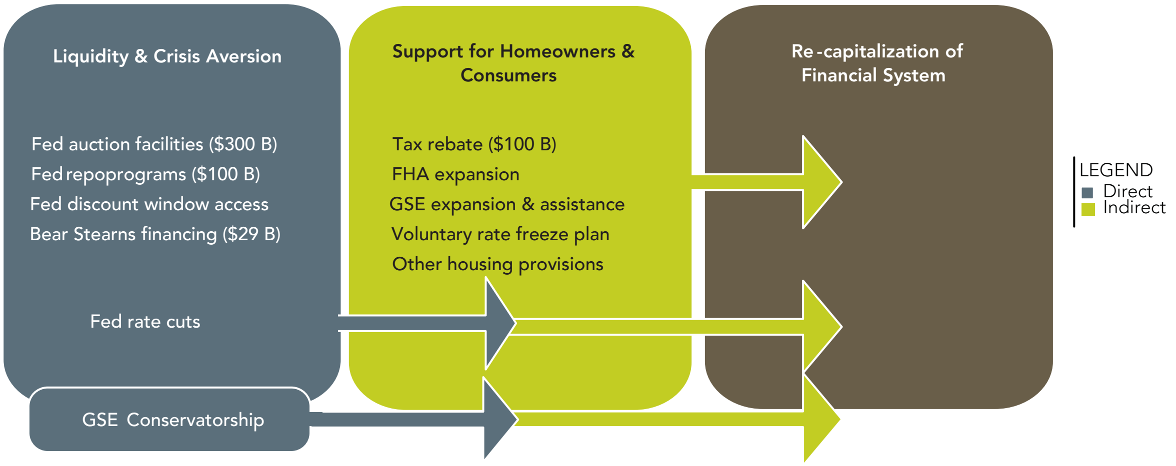
All of these measures are therefore designed primarily to fulfill the first two items on the government response agenda—avoiding systemic collapse and propping-up aggregate demand. They provide only indirect support, however, for recapitalizing the financial system (see *Understanding the Capital Positions of U.S. Financial Firms*, page 4).

Moving To The Next Phase: Need Pain For Gain

The third action step in the financial crisis playbook—disposing of bad assets—is somewhat at odds with the first two and is thus the most difficult balance to achieve. While preventing systemic collapse and boosting aggregate demand are positive actions by the government, the third involves writing off bad assets and allowing insolvent financial institutions to either be acquired or to fail.

If a government goes too far in protecting the system through "bail-outs" of financial companies, it can actually prolong the time it takes the system to recover. In Japan during the early 1990s, for example, officials did lower interest rates and moved to avoid a systemic collapse, but they allowed insolvent banks to survive and maintain large amounts of impaired assets on their balance sheets. As a result, the banking system only got worse, as lenders were saddled with massive amounts of bad loans, and their inability to make new loans had a severe impact on the economy. The

EXHIBIT 1: Government Actions to Stem Financial and Housing Crisis



Source: FMRCo (MARE)

Japanese financial system did not begin to recover until actions to remove bad loans began in the mid-to-late 1990s, with the system really not stabilizing for more than a decade after the onset of the crisis.

No "Bear" Rescue For Lehman; Limits To Government Involvement

When the federal government decided not to provide rescue financing for an acquisition of Lehman Brothers, as it did with Bear in March, it entered a new phase of the credit crisis that is marked by more discriminate use of government support. Lehman was different than Bear for two main reasons. First, unlike Bear, Lehman's demise has been a possibility for months, which made a Lehman collapse much less of a threat to the overall financial system because other financial entities had time to plan for such an eventuality.* Second, if the systemic threat can indeed be contained, it was time to move to the phase of the clean-up marked by more asset write-downs and institutional failures—a painful but necessary stage to ensure the government does not prop-up insolvent institutions in a manner that prolongs the crisis and impedes recovery (i.e. Japan).

The rationale for this latter phase of the crisis is that if the system itself is secure, healthy financial institutions will gobble up distressed firms and assets at attractive prices, allowing them to improve their own profitability. Bad assets that no one wants will be removed completely from the balance sheets of financial entities. Through this admittedly painful process, the healing will begin as financials regain their footing, investor confidence, and are able to recapitalize themselves through greater profitability and/or new share offerings.

Will It Be Enough?

Disposing of bad assets and allowing financial firm failures are a necessary part of restoring order to a financial system after a crisis. Whether they are sufficient depends on the speed and ability with which the surviving firms are able to recapitalize their balance sheets. Financial firms are struggling to recapitalize themselves because the two primary methods of building capital are severely challenged in the current environment. First, shrinking profits are constraining efforts to increase capital positions. Second, declining share prices are making it increasingly difficult to raise equity capital by issuing new shares to private investors.

The one thing the federal government has yet to do is use public funds to directly recapitalize the financial system. Much public assistance has been pledged, but things such as Federal Reserve rate cuts and lower mortgage lending rates from Fannie and Freddie take time to work through the system.

Directly injecting taxpayer money into the financial system has been done on previous occasions, most recently in 1989 during the savings and loan crisis. Back then, the Resolution Trust Corporation was created basically to put insolvent banks out of business, sell off their assets, and recapitalize (with taxpayer money) the healthier banks and lenders that remained solvent. The cost was significant (about 3% of GDP), but the program was generally successful in getting the banking system back on its feet. Today, understandably, the government has been reluctant to pledge public money to directly recapitalize the financial system. Whether it will be able to maintain that luxury will depend largely on how well financial institutions cope with the latest bout of turmoil.

Investment implications

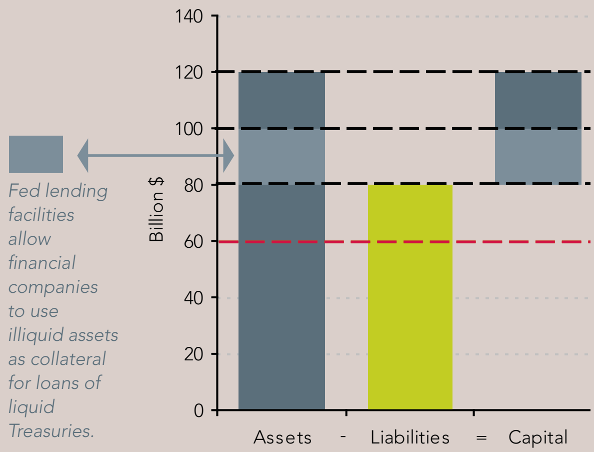
As we mentioned in a recent article (see *U.S. Government Assumes Leading Roles in Mortgage Market*), the credit crisis is not over. The most recent unsettling events, including the disappearance of two of Wall Street's oldest and largest independent institutions, are part of a painful yet necessary process of healing. The government, through both the Federal Reserve and the Treasury Department, continues to be extremely active in providing liquidity to the financial markets, acting to boost housing demand, and committed to averting a financial system collapse. It is too fluid a situation to know how these latest developments will affect the trajectory of the economy and financial markets, and as a result it remains to be seen whether a larger taxpayer-funded effort will be necessary. However, as bad as the current headlines appear, the silver lining is that the government is acting to avoid the worst mistakes of the past, when policymakers prolonged credit crises into decade-long catastrophes.

Understanding the Capital Positions of U.S. Financial Firms

Massive write-downs of assets (such as securities with uncertain market value) can reduce the capital that allows financial institutions to provide credit to customers and businesses.

If the capital positions of a financial firm become negative, then the firm is technically insolvent. Capital is simply the difference between a firm's assets and liabilities, and the more capital a firm has the more credit it can provide to consumers and businesses, or use for other activities. With the massive asset write-downs of mortgages and other securities, capital has shrunk considerably for many U.S. financial firms making recent headlines. The Federal Reserve has taken many steps in an effort to inject liquidity into struggling financial institutions, including the emergency expansion of lending facilities on September 14, 2008. However, neither the Fed's nor the Treasury Department's actions, in and of themselves, directly recapitalize the financial system. Recapitalization occurs through retaining profits, issuing new shares or potentially through a direct capital infusion from the U.S. government (similar to the savings and loan bailout in 1989).

How Write-Downs At A Financial Firm Can Influence Its Capital Base



A — Before any write-downs, the bank has $40B in capital -- everything left when liabilities are subtracted from assets.

B — $20B write-down would reduce the capital base to $20B.

C — $40B write-down would wipe out the capital base ($0).

D — $60B write-down forces the bank into the red. There are now more liabilities than assets and the firm is insolvent.

The diagram to the left is a simple illustration of how large asset write-downs can influence the capital base of a financial company. ■

The above exhibit is a hypothetical example for illustrative purposes only. Source: FMRCo (MARE)

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* Perhaps the largest risk to the broader financial system posed by both Bear Stearns and Lehman Brothers was based in their role as counterparties to various financial contracts, such as credit default swaps and other derivative transactions. If a counterparty is not able to meet its end of an agreement, the value of the contract becomes zero for both parties. Some others voiced concerns over the impact a Lehman bankruptcy would have on trading, since Lehman acted as a specialist (or market maker) in large parts of the securities markets. In order to prevent such circumstances, the International Swaps and Derivatives Association, federal officials, and agents of various Wall Street financial institutions convened a special trading session on Sunday, September 14, 2008 for several hours to assuage these fears. During this window, financial institutions began transferring trades in which Lehman was involved to other parties, contingent on a bankruptcy filing by the end of the day. According to the ISDA, "This exercise is designed to mitigate counterparty credit risk through the establishment of offsetting positions with other market participants."