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BARRON'S COVER

Let It Flow

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The financial-market rescue package is a step in the right direction, but further steps are necessary to get credit flowing again.

Barron's graphics

NECESSARY, BUT NOT SUFFICIENT. That best describes the $700 billion financial-markets rescue package that made its tortured way through Congress last week, finally earning the House of Representatives' OK Friday, along with $152 billion of ancillary goodies for Main Street thrown in to attract the necessary votes.

It is doubtful that passage of legislation establishing the Troubled Asset Relief Program, or TARP, will cure the key ill crippling the capital markets and the U.S. economy: the inability of borrowers to obtain credit from lenders unwilling to extend it. The stock market indicated as much in Friday's session, with the Dow Jones Industrial Average surrendering an earlier gain of 300 points even as President Bush signed the bill in mid-afternoon. Stocks ended the day with a 157-point loss.

The TARP effectively uses the U.S. Treasury's balance sheet to take on impaired mortgage assets from banks and other financial institutions that can't find buyers for such instruments- at least not at anything but giveaway prices. In theory, the TARP would purchase those assets at prices above fire-sale levels, but not so far above that the government -- that is, taxpayers -- couldn't profit down the road, even if that road is long and bumpy.

The Treasury could fund the TARP by issuing securities that, because of the strong demand for government paper, pay less than 2% for shorter maturities. At the same time, it could earn double-digit returns on the assets as they are resold. Think of it as the mother of all "carry trades" -- trader lingo for borrowing at low cost to invest in higher-yielding assets.

The idea behind the TARP is that sellers of impaired assets would use the cash received from the program to make new loans or investments, thus reliquefying the financial system. But there is no assurance either that holders of such assets could be induced to sell at a loss, or that they'd lend out their newfound cash instead of sitting on it. Depression, after all, is a state of mind as well as a state of the economy.

That's why further action needs to be taken to get credit flowing again, and prevent the current constriction from turning today's economic downturn into something worse.

THE QUICKEST AND EASIEST FIRST step would be an internationally coordinated cut in interest rates carried out by the Big Three central banks -- the Federal Reserve, the European Central Bank, the Bank of Japan -- with the Bank of England, the Swiss National Bank, the Bank of Canada and the Reserve Bank of Australia all joining in.

Until recently, the Fed has had to go it just about alone by slashing its key federal-funds target rate by 325 basis points, or 3.25 percentage points, to 2% from 5.25%. The ECB most notably has stood its ground against rising inflation readings.

In the past few weeks, however, both the economic and financial risks have morphed into a deepening crisis, which has jumped borders and begun to grip Europe. Fortis, the giant Dutch-Belgian bank, was partially nationalized last week; Hypo Real Estate in Germany received a 35-billion-euro ($49 billion) bailout, and U.K. lender Bradford & Bingley was taken over by the British government. The Irish government said it would insure all liabilities to shore up confidence in its financial institutions.

Meanwhile, the Fed has been furiously pumping liquidity into the global banking system, extending massive amounts of credit to U.S. institutions and sharply increasing the so-called swap lines with foreign central banks to $630 billion. These provide dollars to foreign banks that desperately need them.

These measures have succeeded in preventing the pressures in the global money markets only from becoming more dire. Libor, the London interbank offered rate, has crept steadily higher, to 4.33% from under 4%. And Libor is no esoteric foreign interest rate; it is the benchmark for many business loans and many Americans' adjustable-rate mortgages, so its impact is considerable on this side of the pond.

A Fed rate cut is already priced into the financial-futures market, and could provide actual relief to U.S. consumers. Robert Kessler, head of Kessler Cos., a Denver-based manager of fixed-income portfolios, says a cut in the Fed's target rate would translate into a drop in the prime rate, currently 5%. That would lower the cost for loans pegged to the prime, such as many home-equity lines of credit, and help put money in the pockets of consumers, the lack of which is at the core of the economy's woes.

Fed-funds futures fully discount a half-point reduction in the target rate by the time the Federal Open Market Committee holds its next regularly scheduled meeting Oct. 29. Indeed, a sharp drop in employment and a marked weakening in the ISM purchasing managers' index in September would argue for rate cuts even in the absence of a credit crunch.

Jean-Claude Trichet, the head of the ECB, said last week that the topic of rate cuts came up at the European Central Bank's most recent meeting. Japan's economy is contracting, too, so its central bank shouldn't be averse to at least a symbolic cut, even though its key policy rate is just 0.5%.

But, as the Japanese experience of the 1990s demonstrated, low interest rates alone will not spur lending. Other steps are necessary.

ONE FEATURE OF THE Emergency Economic Stabilization Act, the official name for the legislation signed Friday, requires the Securities and Exchange Commission, in consultation with the Fed and the Treasury, to study the impact of so-called mark-to-market accounting, and report back to Congress in 90 days.

Mark-to-market accounting, which stipulates that assets be carried on balance sheets at their current market price, has been blamed for exacerbating the credit crisis. By requiring writedowns on loans and securities that have declined in price, institutions have to make a corresponding reduction on the other side of the balance sheet, to capital. That only worsens the credit crunch.

"Ending the credit crisis will be highly unlikely without some type of accounting accommodation," according to Bridgewater Associates, the highly respected institutional money manager. "Because mark-to-market accounting on existing assets threatens bank capital today, it increases solvency concerns today, which raises funding costs and accelerates the need to sell assets today, which depresses the prices of those assets, which threatens capital and raises funding costs.

It's Ugly Out There

The credit crunch has sparked a stampede into Treasuries and sharply curtailed lending to all but the most creditworthy. Wall Street's agony is becoming Main Street's, too.

	Recent Yield	Year-Ago Yield
Interest rates on "safe haven" debt have fallen sharply...		
Federal funds rate	2%	4.75%
3-month Treasury bill	0.678	3.953
10-year Treasury note	3.712	4.561
30-day AA-rated non-financial commercial paper	2.00	4.79
...while rates on most loans have remained relatively flat.		
30-year home mortgage	6.02%	6.20%
Four-year car loan	6.52	6.91
3-month Libor	4.15	5.24
Merrill Lynch investment-grade municipal-bond index	4.95	4.41
Rates on some "risky" loans have soared...		
30-day AA-rated asset-backed commercial paper	6.05%	5.28%
30-day A2/P2-rated non-financial commercial paper	5.42	5.31
Jumbo home mortgages	7.27	7.09
Merrill Lynch high-grade corporate bond index	7.81	5.91
Merrill Lynch high-yield corporate bond index	13.93	8.70
...and credit is getting harder to obtain.		
Loan originations	**2008**	**2007**
Conforming mortgages (2Q, bil)	$288	$325
Jumbo mortgages (2Q, bil)	26	120
Home-equity loans (2Q, bil)	35	104
Applications approved		
Prime car loans (Sept.)	79%	90%
Subprime car loans (Sept.)	20%	67%
Other		
Fed Survey: banks tightening lending standards (July)	60%	9%
Total commercial paper outstanding (Oct., tril)	$1.61	$1.86

Sources: CNW Research, Federal Reserve, Merrill Lynch, Inside Mortgage Finance, WSJ Market Data

"This cycle can be broken if banks communicated an accurate or conservative assessment of the fair value of their assets in the footnotes of their financial statements, thereby telling equity and bond investors what they need to know to value the company. But if these losses were accrued over the remaining life of the assets, thereby avoiding the immediate hit to the book value of capital, the selling pressure would be reduced, which might even allow prices to rise and reverse the cycle and improve sentiment. This seems pretty obvious without any knowledge of history, but history overwhelmingly confirms the need for such a change."

Bridgewater's proposal isn't the same as more radical suggestions to suspend so-called fair-value accounting. Indeed, ignoring current market values of assets would only heighten the lack of faith investors display for current book values.

"Many of the current requirements stem from the Savings & Loan crisis in the 1980s, when we learned that not knowing the real, current values of financial instruments held by financial institutions can be devastating when the bubble finally bursts and institutions are

forced to close their doors," executives at the Center for Audit Quality wrote in a letter to the heads of the Fed, Treasury and SEC, urging them not to back off from mark-to-market standards.

But there should be a middle ground between simply accepting a historical cost and forcing assets that are not in default to be written down to current prices, notably those based on indexes of credit derivatives that frequently diverge from the prices of the actual underlying assets.

Last week, the SEC and the Financial Accounting Standards Board attempted to forge such a via media, or middle way. When no active market for a security exists, management may estimate values from market expectations of future cash flows and an appropriate risk premium, they wrote in a release. In other words, assets don't have to be valued based on current low-ball bids in a dysfunctional market. But the assets do have to reflect reasonable expectations of their payoff and risks, to satisfy investors and auditors. Does Arthur Andersen ring a bell?

THE KEY REASON TO limit mark-to-market losses is to preserve capital, whose conservation is the main constraint on the financial system.

"To get credit growing again, the financial system needs to bolster its capital," says Paul Kasriel, director of economic research at Northern Trust Co. "Without capital, financial institutions cannot extend more credit to the private sector. Offers by the central bank to fund financial institutions at a low interest rate will not, in and of itself, stimulate credit creation if financial institutions do not have the capital to support this new lending."

The government can inject capital into institutions, as the Treasury did with Fannie Mae and Freddie Mac through the purchase of preferred stock.

Or, as the Fed did with its loan to American International Group, which will give the central bank warrants to buy 79.9% of the insurer. Kasriel notes that warrants or additional preferred reduces the value of outstanding shares.

"TARP appears to be a Rube Goldberg-type of government capital-injection program," he says. If it overpays for assets, it bolsters the capital of banks and other financial institutions; if it protects taxpayers' interests, as it's supposed to do, they would get the overpayment, not the institution. So, it's not clear how TARP fixes the capital problem.

NOURIEL ROUBINI, the New York University economist whose Cassandra-like warnings about the impact of the credit crisis should have been heeded, says radical steps will be needed, including government capitalization of the banking system.

The government will have to arrange "triage" to decide which banks are solvent and able to survive, Roubini said on a conference call last week. Those that survive will receive an injection of equity. Deposits of all banks, including those allowed to fail, will have to be insured by the government, he added.

To the Bank Credit Analyst, the $700 billion rescue plan represents "the effective socialization of financial intermediation." With increased government capital will come increased oversight.

"Because high leverage was the villain in this piece, presumably the regulators and the markets will demand less leverage going forward," says Northern Trust's Kasriel. "Lower

leverage implies slower credit growth, unless a lot of new capital migrates to the financial sector."
Adds the Bank Credit Analyst: "Banks will be under pressure to contract balance sheets, even as they sell toxic assets to the Treasury. There has been a huge overshoot in lending in recent years, and a return to trend (or below) seems inevitable."

THE CONGRESS PASSED, and the President has signed, legislation to use the Treasury's balance sheet to counter such a doleful prospect (and not to bail out "Wall Street greed and corruption," as GOP vice presidential candidate Sarah Palin kept repeating in last week's debate). At a minimum, further steps -- including coordinated interest-rate cuts, accounting forbearance and additional bank capital -- will be needed to keep credit from contracting further.

Clearly, the failure of the rescue legislation's passage to elicit a positive reaction shows more needs to be done. It is far from "Mission Accomplished" on the credit campaign.