The financial crisis

Wall Street's bad dream

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In a special nine-page report, we look at how the global financial system has fallen into the grip of panic

“THINGS are frankly getting out of hand and ridiculous rumours are being repeated, some of which if I wrote down today and re-read tomorrow, I’d probably think I was dreaming.” So said an exasperated Colm Kelleher, Morgan Stanley’s finance chief, during a hastily arranged conference call on September 16th.

The carnage of the past fortnight may have an unreal air to it, but the damage is all too tangible—whether the seizure of Fannie Mae and Freddie Mac by their regulator, the record-breaking bankruptcy of Lehman Brothers (and the sale of its capital-markets arm to Barclays), Merrill Lynch’s shotgun marriage to Bank of America or, most shocking of all, the government takeover of a desperately illiquid American International Group (AIG).

The rescue of the giant insurer was justified on the grounds that letting it fail would have been catastrophic for financial markets. As it happened, even AIG’s rescue did not stop the bloodletting. On September 17th shares in Morgan Stanley and the other remaining big investment bank, Goldman Sachs, took a hammering. Even though both had posted better-than-expected results a day earlier, confidence ebbed in their stand-alone model, with its reliance on flighty wholesale funding. An index that reflects the risk of failure among large Wall Street dealers has climbed far above its previous high, during Bear Stearns’s collapse in March (see chart).

It is a measure of the scale of the crisis that, by the evening of September 17th, all eyes were on Morgan Stanley, and no longer on AIG, which only 24 hours before had thrust Lehman out of the limelight. After its share price slumped by 24% that day, and fearing a total evaporation of confidence, Morgan attempted to sell itself. Its boss, John Mack, reportedly held talks with several possible partners, including Wachovia, a commercial bank, and Citic of China. As contagion spread far and wide, on September 18th central banks launched a co-ordinated attempt to pump $180 billion of short-term liquidity into the markets. HBOS, Britain’s biggest mortgage lender, also sold itself to Lloyds TSB, one of the grandfathers of British banking, for £12.2 billion ($21.9 billion) after its share price plunged. The government was so anxious to broker a deal that it was expected to waive a competition inquiry.

Know thine enemy

CDR Counterparty Risk Index, basis points

Source: Credit Derivatives Research

Financial panics have been around as long as there have been organised economies. There are common themes. The cause of today’s crunch—the buying of property at inflated prices in the hope that some greater fool will take it off your hands—has featured many times in the past. And the withholding of funds by institutional investors is merely the modern version of an old-fashioned bank run.

The same, and yet different

But each has its own characteristics, which makes it difficult for students of past crises to apply lessons. Ben Bernanke, the chairman of the Federal Reserve, may be a scholar of the Depression, but the vastness and complexity of the financial system, and the speed with which panic is spreading, create a daunting task.

Though they are putting on a brave face, officials could be forgiven for feeling at a loss as one great name buckles after another and investors flee any financial asset with the merest whiff of risk. Even the politicians have been stunned into inactivity. Congress probably will not pass new financial legislation this year, admitted Harry Reid, the Senate majority leader, because "no one knows what to do."

At times, the responses appear alarmingly piecemeal. Amid a fresh clamour against short-sellers—Morgan Stanley's Mr Mack accused them of trying to wrestle his stock to the ground—the Securities and Exchange Commission, America's main markets regulator, brought back curbs on "naked", or potentially abusive, shorts. It also rushed out a proposal forcing large investors, including hedge funds, to disclose their short positions. Calstrs, America's second-largest pension fund, said it would stop lending shares to "piranhas".

As in August 2007, when the crisis began in earnest, money markets were this week seizing up. The price at which banks lend each other short-term funds surged, leaving the spread over government bonds at a 21-year high. A scramble for safety pushed the yield on three-month Treasury bills to its lowest since daily records began in 1954—the year President Eisenhower introduced the world to domino theory.

Aptly enough, the crisis is spreading from one region to the next. Asian and European stock markets suffered steep falls. Japan was fretting that Lehman's potential default on almost $2 billion of yen-denominated bonds would send a chill through the "samurai" market. Russia suspended share-trading and propped up its three largest banks with a handy $44 billion, as emerging markets lost their allure.

Another weak spot is the $62 trillion market for credit-default swaps (CDSs), which has given regulators nightmares since the loss of Bear Stearns. It did not fall apart after the demise of Lehman, another big dealer. But it remains fragile; or, as one banker puts it, in a state of "orderly chaos".

CDS trading volumes reached unprecedented levels this week, and spreads widened dramatically, as hedge funds and dealers tried to unwind their positions. But as margin requirements rise, few participants are taking on much risk, according to Tim Backshall of Credit Derivatives Research. The turmoil will embolden those calling for the opaque, over-the-counter market to move onto exchanges. Nerves on Wall Street would be jangling less if a central clearinghouse, planned for later this year, was already up and running.

The CDS market may have figured in the government's calculations of whether to save AIG, given that its collapse would have forced banks to write down the value of their contracts with the insurer, further straining their capital ratios. But officials also had an eye on Main Street. Some of AIG's largest insurance businesses serve consumers; its failure would have shaken their confidence. As it was, thousands lined up outside its offices in Asia, with some looking to withdraw their business.

Consumers are already twitchy in America, where bank failures are rising and the nation's deposit-insurance fund faces a potential shortfall. The failure of Washington Mutual (WaMu), a troubled thrift, could at the worst wipe out as much as half of what remains in the fund, reckons Dick Bove of Ladenburg Thalmann, a boutique investment bank. WaMu was said this week to be seeking a buyer.

No less worrying are the cracks appearing in money-market funds. Seen by small investors as utterly safe, these have seen their assets swell to more than $3.5 trillion in the crisis. But this week Reserve Primary became the first money fund in 14 years to "break the buck"—that is, to expose investors to losses through a reduction of its net asset value to under $1—after writing off almost $800m in debt issued by Lehman.

Any lasting loss of confidence in money funds would be hugely damaging. They are one of the last bastions for the ultra-cautious. And they are big buyers of short-term corporate debt. If they were to pull back, banks and large corporations would find funds even harder to come by.

Coming to a bank near you

At some point the Panic of 2008 will subside, but there are several reasons to expect further strain. Banks and households have started to cut their borrowing, which reached epic proportions in the housing boom, but they still have a long way to go. By the time they are finished, the pool of credit available across the markets will be smaller by several trillion dollars, reckons Daniel Arbess of Perella Weinberg Partners, an investment and advisory firm. A recent IMF study argued that the pain of deleveraging will be felt more keenly in Anglo-Saxon markets, because highly leveraged investment banks exacerbate credit bubbles, and are then forced to cut their borrowing more sharply in a downturn.

Furthermore, it is far from clear, even now, that banks are marking their illiquid assets conservatively enough. Disclosures accompanying third-quarter results, for instance, showed a lot of disparity in the valuation of Alt-A mortgages (though definitions of what constitutes Alt-A can vary). "Level 3" assets, those that are hardest to value, will remain under pressure until housing stabilises—and that may be some time yet. Jan Hatzius of Goldman Sachs expects house prices in America to fall by another 10%. Builders broke ground on fewer houses than forecast in August, suggesting the housing recession will continue to drag down growth.

The pain is only now beginning in other lending. "We may be moving from the mark-to-market phase to the more traditional phase of credit losses," says a banker. This next stage will be less spectacular, thanks to accrual accounting, in which loan losses are realised gradually and offset by reserves. But the numbers could be just as big. Some analysts see a wave of corporate defaults coming. Moody's, a rating agency, expects the junk-bond default rate, now 2.7%, will rise to 7.4% a year from now. Like many nightmares, this one feels as if it will never end.