**TEXT 4** - **Banking**

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Finance and economics

American banks

**When sorrows come**

Aug 28th 2008 | NEW YORK
From *The Economist* print edition

**Commercial banks prepare, reluctantly, to take centre stage**

EVERY episode in the credit crunch has had its dramatic flourish. There were the defenestrations at Citigroup and Merrill Lynch late last year; then, in March, the Bear Stearns fiasco; the humbling of UBS; and now Fannie Mae and Freddie Mac, a tale of hubris that might impress Shakespeare himself. What next?

With the tragedy of the mortgage giants still unfolding, another dark drama is entering its second act, and it has rather a lot of players. It concerns America's commercial banks. "Pretty dismal" was the frank description of their recent performance offered on August 26th by Sheila Bair, head of the Federal Deposit Insurance Corporation (FDIC). That was just after announcing a rise in the number of banks on its danger list, from 90 to 117.

Nine banks have failed so far this year, felled by shoddy lending to homeowners and developers—six more than in the previous three years combined. The trajectory is steep: Institutional Risk Analytics, which monitors the health of banks, expects more than 100 lenders—most, but by no means all, tiddlers—to fold over the next year alone. Alarmingly, the ratio of loan-loss provisions to duff credit is at its lowest level in 15 years.

The FDIC will soon have to replenish its deposit-insurance fund, which collects premiums from banks and stood at around $53 billion before the downturn. One of this year's failures, IndyMac, has alone depleted the fund's coffers by one-sixth—and it was no giant. This has pushed the fund's holdings below a trigger point that requires the FDIC to craft a "restoration" plan within 90 days.

Ms Bair has indicated that banks with risky profiles—which already pay up to ten times more than the typical five cents per $100 insured—will be asked to "step up to the plate" with even higher premiums. This would ensure that safer banks are not unfairly burdened. But it will heap yet more financial pressure on strugglers. Bankers' groups have already started to protest loudly.

How much will be needed? Possibly far more than the FDIC is letting on, reckons Joseph Mason of Louisiana State University. Extrapolating from the savings and loan crisis of the early 1990s, and allowing for the growth in bank assets, he puts the possible cost at $143 billion.

That would force the FDIC to go cap-in-hand to the Treasury. The need to do so could become even more pressing if nervous savers began to move even insured deposits (those under $100,000) away from banks they perceived to be at risk—which no longer looks fanciful given the squeeze on the fund. Ms Bair's admission, in an interview with the *Wall Street Journal*, that the FDIC might have to tap the public purse, albeit only for "short-term liquidity purposes", will have done little to calm nerves.

It is also sure to reinforce a growing sense that the financial-market crisis has a lot further to run. Risk-aversion, measured by spreads on corporate debt, fell sharply after the sale of Bear Stearns in March but has leapt back in recent weeks as the spectre of systemic meltdown resurfaced. Sentiment towards spicier assets is astonishingly grim: prices of junk bonds and home-equity loans imply a default rate consistent with unemployment of around 20%, points out Torsten Slok, an economist at Deutsche Bank.

**Measure for measure**

Banks continue to tighten credit, and their own belts—Citigroup has even restricted colour photocopying. What liquidity they have is being jealously hoarded, partly out of distrust of one another, but mostly in anticipation of refinancing requirements on bonds that they issued with abandon in the credit boom. The spread over expected central-bank rates that they charge one another for short-term cash has risen to three times the level that it was in January. Worse, derivatives markets point to a further increase. Another measure of trust, or lack of it, the index of the "counterparty" risk that derivatives dealers pose, is creeping back towards its March peak.

Nor have investors grown any more confident about their ability to price the banks' toxic mortgage-backed assets: Merrill Lynch's cut-price sale of collateralised-debt obligations in July has had few imitators. Lehman Brothers has tried unsuccessfully to sell a pile of iffy securities backed by commercial mortgages all summer.

The woes of Fannie Mae and Freddie Mac weigh on these efforts. Bankers feel obliged to advise clients against snapping up distressed securitised assets until the mortgage giants are put on a firmer footing, says one. And banks themselves are exposed: paper issued by the mortgage agencies accounts for roughly half of their total securities portfolios, estimates CreditSights, a research firm. American banks own much of the preferred stock (a hybrid of debt and equity) that the two firms issued. They were attracted by the preference shares' combination of a low risk weighting and decent yield, says Ira Jersey of Credit Suisse, but have seen their prices tumble on fears that they will be wiped out if the government moves to prop the agencies up. Although only a few regional lenders would be seriously hurt by this, it would add to the pain of many. JPMorgan Chase has just become the first bank to write down its holdings, saying it may lose $600m, or half the value it had put on them. That may start a trend.

Worse, banks have come to rely on issuing their own preference shares to raise capital, and will find that harder if holders of Fannie's and Freddie's paper suffer losses. Banks have raised a total of $265 billion of capital since last summer, says UBS. With much of that issuance underwater, investors are understandably wary of throwing good money after bad.

Contagion also spreads through the market for credit-default swaps. Banks have busily written such insurance contracts on Fannie's and Freddie's $20 billion of subordinated debt, which sits below senior debt in their capital structures. If the debt's holders suffer losses in a bail-out, triggering a "credit event", banks that had sold the swaps would face huge payouts. The amounts involved are "impossible to calculate but far from trivial", says one sombre analyst. As the bard wrote: "When sorrows come, they come not single spies, but in battalions."