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Commentary

Market Opinions and Topics of Interest

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What Will It Take To End The Credit Crisis?

The following will appear this weekend in the Nikkei Publication Veritas in Japanese

The financial system collectively has lost $240 billion of capital through April 2008. The largest portion, approximately $210 billion, has come from writedowns of the now-infamous collateralized debt obligations (CDOs), with the remaining $30 billion derived from actual losses.

Total Banking System Losses
As of April 10, 2008
Billions of U.S. Dollars

Firm	Writedown	Credit Loss	Total
UBS	38.0		38.0
Merrill Lynch	25.1		25.1
Citigroup	21.4	2.5	23.9
Morgan Stanley	12.6		12.6
HSBC	3.0	9.4	12.4
IKB Deutsche	9.1		9.1
Washington Mutual	0.3	8.4	8.7
Bank of America	7.3	0.9	8.2
European Banks Not listed	7.9		7.9
Deutsche Bank	7.5		7.5
Credit Agricole	6.6		6.6
Credit Suisse	6.4		6.4
JPMorgan Chase	2.9	2.1	5.0
Wachovia	2.9	2.0	4.9
Other Asian banks (excluding Mizuho, Nomura)	4.0	0.7	4.7
Canadian Imperial (CIBC)	4.1		4.1
Societe Generale	3.9		3.9
Bayerische Landesbank	3.7		3.7
Mizuho Financial Group	3.4		3.4
Lehman Brothers	3.3		3.3
West LB	3.3		3.3
Barclays	3.2		3.2
Etrade	2.5	0.6	3.1
Royal Bank of Scotland	3.1		3.1
Goldman	3.0		3.0
Dresdner	2.8		2.8
Bear Stearns	2.6		2.6
Other Canadian banks (excluding CIBC)	2.4	0.1	2.5
ABN Amro	2.5		2.5
Fortis	2.4		2.4
HSH Nordbank	2.3		2.3
Natixis	1.9		1.9
Wells Fargo	0.3	1.4	1.7
BNP Paribas	1.4	0.3	1.7
DZ Bank	1.5		1.5
National City	0.4	1.0	1.4
LB Baden Wuerttemberg	1.3		1.3
Bank of China	1.3		1.3
Caisse d'Epargne	1.3		1.3
Nomura Holdings	1.0		1.0
Sumitomo	1.0		1.0
Gulf International	1.0		1.0
Total*	**215.9**	**29.4**	**245.3**

Source: Bloomberg L.P.

These losses have been offset partially by financial firms raising $140 billion in new capital.

Total Banking System Capital Raised
As of April 16, 2008

Firm	Infusion ($blns)	Investor
UBS (a)	$ 11.00	Government of Singapore Investment Corp.
	$ 15.00	Public Investors
	$ 2.00	Unidentified Middle Eastern Investor
Citigroup	$ 6.90	Government of Singapore Investment Corp.
	$ 5.60	Kuwait, Prince Alwaleed, Capital Research, Capital World, Sandy Weill, Public Investors
	$ 10.40	Public Investors
	$ 7.50	Abu Dhabi Investment Authority
Bank of America	$ 13.00	Public Investors
IKB Duetsche	$ 13.40	German Gov't; Banking Association
Societe Generale	$ 8.80	Public Investors
WestLB	$ 7.90	State of North Rhineland Westphalia, savings banks associations, regional governments
Merrill Lynch	$ 5.00	Temasek Holdings
	$ 6.60	Korean Investment Corp, Kuwait, Mizuho
	$ 1.20	Davis Selected Advisors (U.S.)
Morgan Stanley	$ 5.00	China Investment Corp.
Wachovia	$ 3.50	80 U.S. Investors
	$ 7.00	Public Investors
WaMu	$ 3.00	Public Investors
	$ 2.00	TPG Inc.
	$ 5.00	Institutional investors
Canadian Imperial	$ 1.50	Li Ka-Shing, Manulife, Caisse de Depot, OMERS
	$ 1.40	Public Investors
Lehman Brothers	$ 4.00	Public Investors
Barclays (b)	$ 3.00	China Development Bank
	$ 2.80	Public Investors
	$ 2.00	Temasek Holdings (Singapore)
HSBC	$ 2.00	Public Investers
National City	$ 1.90	Public investors
Etrade	$ 1.80	Blackrock inc, Citadel, other investors
Credit Suisse	$ 1.40	Public Investors
Gulf Int'l	$ 1.00	Gov'ts of Bahrain, Kuwait, Oman, Qatar, Suadi Arabia, UAE
Total	**$ 162.60**	

Source: Bloomberg

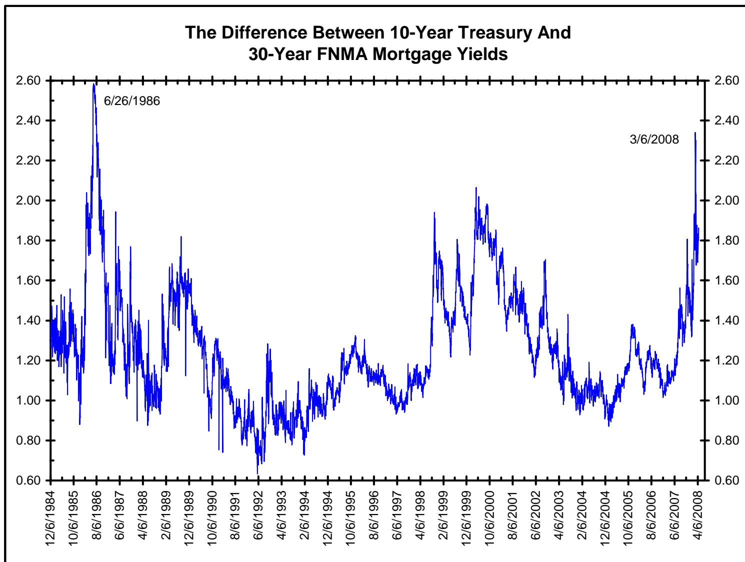
While the CDO writedowns appear to be near the end by virtue of exhausted supply, the damage has been done.

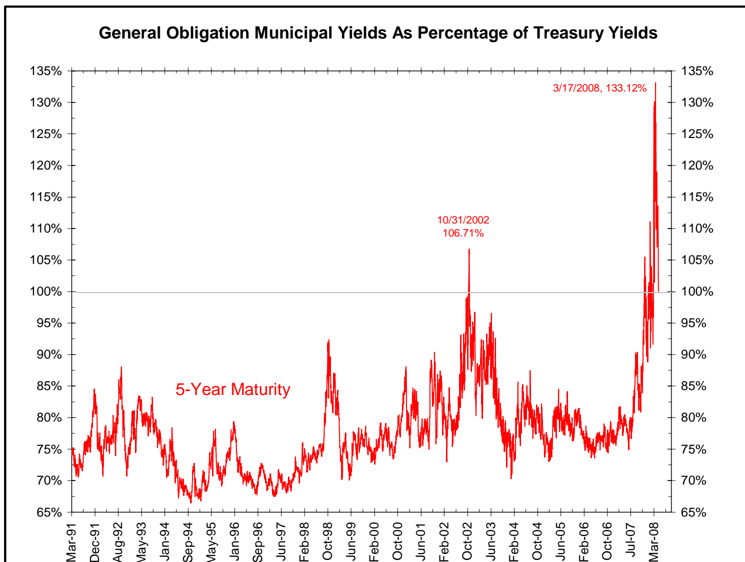
The typical financial firm is leveraged 14:1. This means the net loss of $100 billion in capital translates into a $1.4 trillion reduction of credit worldwide. Or, the world has $1.4 trillion less of credit than it did a year ago. Real economic growth over the past year has been above zero and asset markets have expanded. A growing economy and expanding markets cannot coexist with a shrinking financial system.

Looking At The Credit Spectrum

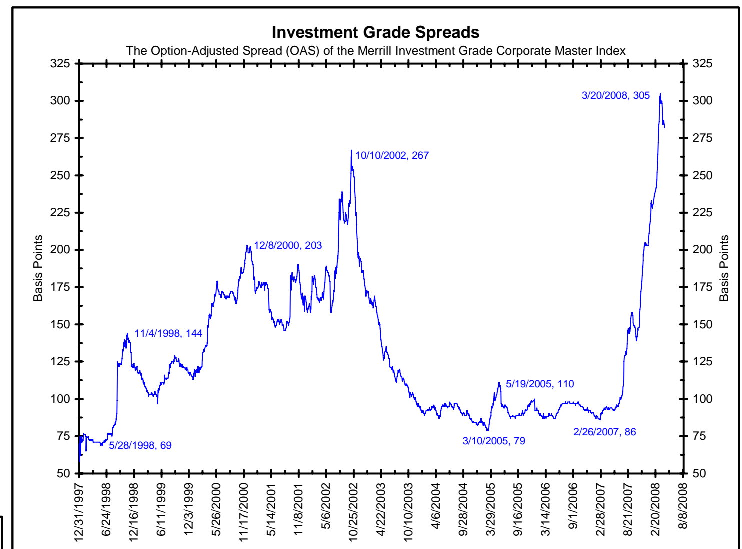
The result has been one three-letter acronym financing vehicle (i.e., SIV, ARS) after another experiencing trouble. This is a result of credit being rationed haphazardly, not through the normal mechanism of interest rates, but rather through supply constrictions.

This has, in turn, led to unusual activity wherein the highest credit quality instruments are doing far worse than lesser quality. Phrases like “worst day ever” and “widest spreads in decades” are often said in conjunction with instruments with credit quality near U.S government securities such as federal agencies, mortgage-backed securities and municipal bonds.

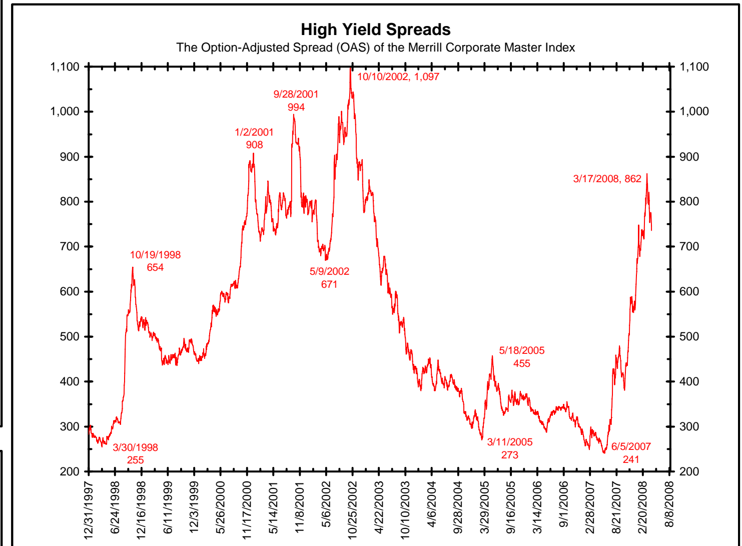




Investment-grade bonds, one notch down on the credit spectrum, are more stressed than their worst levels in 2002.



However, high-yield bonds are not as stressed as comparable levels in 2002.



Finally, at the bottom of the credit spectrum, equities have yet to meet the commonly accepted bear market definition of a 20% decline.

Why The Best Credits Do Worse

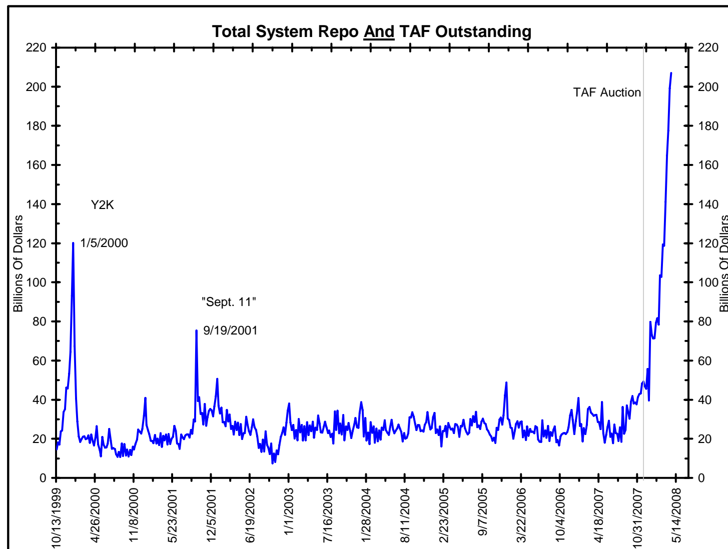
Many have mistaken this unusual action of the best credit quality doing relatively worse as a sign credit ratings themselves are mistaken. In response, they proposed the federal government either guarantee the payment of municipal bonds or require government sponsored entities to guarantee so-called jumbo mortgages. These solutions are misguided. The problem never has been the credit quality of the securities. The problem is on the liability side.

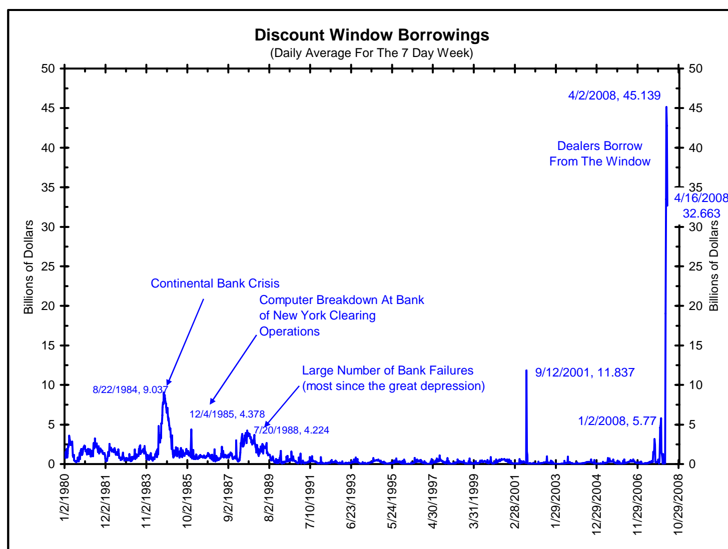
High-quality credit instruments have a very small chance of defaulting. Therefore, they are favorites of hedge funds and other leveraged investors to buy with lots of borrowed money. A recent example of

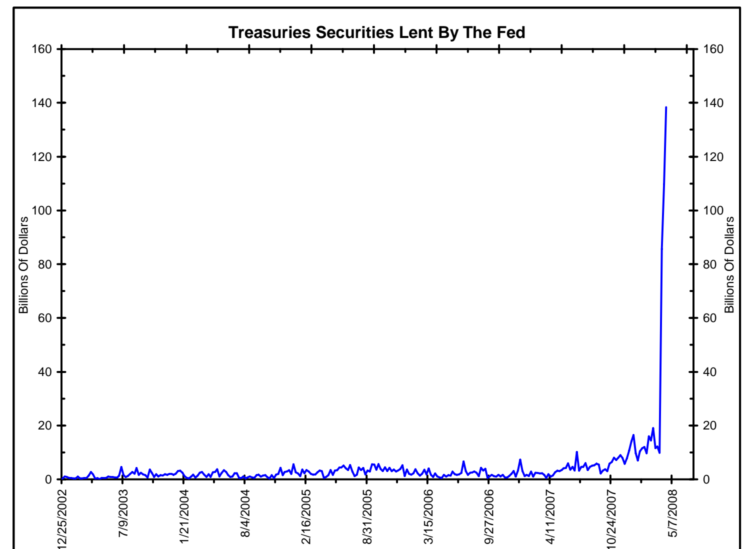
this was Carlyle Capital's 32:1 leverage in owning federal agency and mortgage-backed securities; specifically, $800 million of equity supported $30 billion of securities. The shrinking financial system has made such leverage unavailable at present. More importantly, highly leveraged investors are being forced to reduce leverage by adding additional equity, selling securities or both.

Enter The Federal Reserve

Recent attempts by the Federal Reserve to rectify credit crisis also are missing the mark. The Fed has tools to deal with a liquidity crisis. The purpose of the Fed's collateralized loans program is to address liquidity concerns.







In normal times, the Fed is constantly tinkering with the levels in the member banks' reserve accounts. At present, instead of making its member banks buy and sell possibly illiquid securities, these instruments can be posted as collateral for short-term loans, usually overnight, for banks to stay in balance with their reserve requirements.

If the banking system's problem was being under-reserved, then the Fed's action of dramatically expanding these lending programs makes sense. But, this is not the problem.

Conclusion

The problem is the entire financial system's capital base is shrinking. In addition, financial firms do not trust the economic health of their counterparties. So, they are forcing a de-leveraging of positions to reduce exposure with these counterparties.

This is a more complex problem than merely over-reserving member bank accounts or using illiquid securities as collateral in a loan. That illiquid collateral still belongs to the financial firm and if its value continues to shrink, its capital is further eroded. This will make the bank less likely to do anything aggressive with the funds from the loan or from the more liquid Treasury securities received.

For this crisis to truly end, more collateralized loans are not the answer. More capital, in excess of the losses to-date, is the answer. This way the financial system again can expand to meet the needs of the real economy. This is painful for existing shareholders because of its dilutive nature. Financial executives are willing to do or try anything else before being forced into this option, including hoping the Fed's aggressive loan campaign will work.

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