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The US Banking System Is in Trouble
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Fannie, Freddie, and the Credit Crisis
Baltimore, La Jolla, and South Africa

By John Mauldin

Yet another crisis confronts us, as we will have to deal with the aftermath of a rather large number of bank failures over the next year, which is likely to overwhelm the ability of the FDIC to insure your bank deposits. Today we look at the banking system, the FDIC, and Freddie and Fannie. It's not pretty, but as realists we must know what we are facing.

But first, I just want to say I am glad that Richard Russell is doing fine. For those who do not know, he suffered a mild stroke last Friday. I talked to him yesterday, and he was a little tired but doing better. He has decided to cut back his writing schedule and relax a bit more, which is a good thing. At 84, he has written a daily (and sometimes lengthy) commentary and has been writing the monthly *Dow Theory Letter* since 1958. He is the dean of newsletter writers. He has forgotten more than most of us will ever know about the markets.

His doctor told him he needed to seek some balance in his life and cut down on the stress. I know how much it takes to write my one letter each week; I can't imagine what it takes to write five. Basically, his plan is now to post his stats and only write about the markets when something important is happening, about every two weeks. I hope he sticks with that plan, as I want to be sharing dinner and drinks with him for many years to come. I am sure you join me in wishing him and his lovely wife Faye all the best and a healthy and quick recovery.

The US Banking System Is in Trouble

A few weeks ago when I was in Maine, I met Chris Whalen. Chris is the managing director of a service called Institutional Risk Analytics, whose primary business is analyzing the health of banks and financial institutions. If you are one of their clients, you can go to their web site and drill quite deep into all aspects of every bank in America. And what they have done is come up with various metrics which compare how well-capitalized a bank is, how much risk it is taking, and what kind of losses (or profits) it can expect. It is a one of a kind firm, and the data gives Chris a very special perspective on the US banking system.

And what he sees is not pretty. There is a crisis brewing. He expects 100 banks to fail between now and July of 2009. Most of them will be small, but there will be a few large banks. The total assets of those banks he estimates to be $850 billion (not a typo!). Those are the assets the FDIC is going to have to cover when they take over the banks.

It's More Than Freddie and Fannie

Take Washington Mutual as an example. There are problems there. Their debt now trades at 20%, which is worse than junk. There is no way they could issue preferred stock to recapitalize their business. And they are going to need more capital, as they have writedowns in their future due to the slowing of the economy. Any common issue would have to seriously dilute existing shareholders almost to the point of nothing. There are circumstances in which they can survive, but it would take a remarkable recovery for the US economy, which is not likely. Maybe management can pull a rabbit out of the hat, but it will need some strong magic to get the capital they need at a cost they can live with.

The FDIC has about $50 billion. These reserves have been built up over the years from deposit insurance paid by banks that are part of the program. They are going to need an estimated $20 billion just to cover the failure of Indy Mac. The FDIC will have to cover only a small percentage of the $850 billion, as some of those assets will surely be good. But if they have to cover 10%, then the FDIC would need another $50 billion. Does that sound like a lot? Chris thinks a more conservative number for planning purposes would be 20-25% potential losses, and you hope it does not get there.

Sometime in the next few quarters, Congress and the President, either the current group or early in the term of the next President, are going to have to address that potential shortfall, before we see bank runs as people fear that FDIC insurance reserves may not be enough. The very sad fact is that taxpayers are going to be on the hook for some time. What is likely to happen is that a loan facility will be made to the FDIC so they can borrow as much as they need, and pay it back from future bank insurance payments.

You can't make up the shortfall just by raising fees. Chris points out that raising fees right now is not really a winning option, as that just makes the financial books of marginal banks even worse. You can raise rates as the banking system returns to health.

If Congress and the President wait too long, there could be a very serious problem, as depositors could start moving their funds under $100,000 (the insured amount) to what they perceive may be a safer bank than their current bank. Rumors could run rampant. This is something that needs to be addressed now. Frankly, this should be addressed right after the elections AT THE LATEST, in consultation with Congress and the new President.

If you are worried about your bank, you can go to Chris's web site and pay $50 for a brief analysis of your bank and an update for the next four quarters. If you have less than $100,000 in your accounts, you should not worry. But for businesses with large deposits and cash flows, it might be worth checking on the health of your bank. The link is **http://us1.institutionalriskanalytics.com/Cart/Request.asp?affiliate=bmg123**.

You can click on the link that says "Click here for the free samples" in the lower right corner of the page to see if the format of what they offer is something you would find useful.

$500 Billion and Counting

We have seen some $505 billion in bank write-offs so far in this credit crisis. It is serious naiveté to assume that this will be the extent of it. Most of the write-offs have been mortgage-related. We have not yet seen the write-offs that will come as consumers start defaulting on credit cards, auto loans, and other consumer debt. Neither have we seen the losses that will come from commercial real estate or corporate loan as the recession progresses. You can't write off something until it goes bad, although you can increase your loan loss provisions. This of course hits earnings and your stock price and thus your ability to raise new equity. It presents a very difficult dilemma for bank managers and investors deciding whether to invest or go away.

Sober-minded analysis from the IMF suggests that the total write-offs by all banks may be $1 trillion. Dr. Nouriel Roubini is much more alarmed and puts the potential losses at closer to $2 trillion. That means that banks over time are going to have to increase their loan loss provisions, hitting both earnings and capital. And that means they will have to raise more investment capital and equity at a time when their stock prices are low.

It is a vicious spiral. Banks have less capital, so they are able to lend less to the very businesses that need the money; and without said money the businesses will be less capable of paying their current loans, which means that banks have less capital. Rinse and repeat.

That only prolongs the recession and Muddle Through Economy, which hurts consumers and corporate profits, which in turn puts more pressure on banks. Ultimately it means that banks are going to have to raise a lot more capital than anyone who is buying financial stocks today imagines. And it is largely going to be expensive capital. Look at this note from Bennet Sedacca of Atlantic Advisors:

"Financial entities like banks, broker/dealers, regional banks, finance companies, and insurance companies need credit at reasonable rates in order to finance themselves. I have been concerned for many years that the door would finally shut on banks, brokers and others to raise new capital in the debt markets.

"For many regional banks like KeyCorp, Zions, Regions, and National City, the door has already shut on them—if they wanted to raise capital in the debt market at levels where their outstanding issues regularly trade, they would have to pay 12-15%, hardly economic levels. GM bonds trade near 27% yields. Washington Mutual trades north of 15%.

"Then there are the 'good banks', like J.P. Morgan and Wells Fargo. J.P. Morgan recently sold $600 million of preferred stock at 8 ¾ % and Wells Fargo sold $1.3 billion at 8 5/8%, plus underwriting fees.

"Below I offer up a few guesses of what other issuers would have to pay to issue preferred stock.

• Lehman Brothers—11-13%.
• Merrill Lynch—11-12%.
• Morgan Stanley—9-10%.
• Citigroup—9 ½-10 ½%.
• CIT Group—12-15%.
• Fannie Mae/Freddie Mac-—15%
• Keycorp—11-13%.
• National City—13-15%.
• Wachovia—10-12%.
• Zions Bancorp—13-15%.
• GM/GMAC—not possible.
• Washington Mutual—not possible.
• Ford—not possible."

Bennet does note a good point. Banks that conserved capital and managed their risks well will be in good shape to take over weaker brethren. They will have access to the capital markets for the money they need for expansion. My own bank was acquired recently by another small regional bank. Deals are getting done.

In another note, and to illustrate this point, Sedacca points out that it is not just Freddie and Fannie. Besides Washington Mutual, mentioned above, "RF (Regions Financial) needs to raise $2 billion says Sanford Bernstein. Let's see, what are their options? They can sell debt. The problem here is that you couldn't sell debt if you wanted. The last reported trade in RF paper was 2 weeks ago nearly +700 to the 30 year or close to 12%. Their preferreds trade at 10% and the stock is now a 'single digit midget' near $8 a share. So if you could even get a deal done, shareholders would get a 50% haircut."

Fannie, Freddie, and the Credit Crisis

Let's turn to Freddie and Fannie. There must be some people who think there is some way that the shareholders of Fannie and Freddie will not lose everything, as their shares actually trade. This just simply goes to show that you can fool some of the people some of the time. And as we will see, some of those people are very serious institutions.

It is almost a forgone conclusion that the US Treasury will have to step in and for all intents and purposes nationalize the two government-sponsored enterprises. The estimated losses in these two firms are far beyond what they could raise in a traditional market. And the longer the government waits, the worse the situation is likely to get.

Moody's downgraded the preferred stock in these firms to almost junk level because of the increased likelihood of "direct support" from the US Treasury, which, depending on the nature of the support, could wipe out both the holders of the common and the preferred. The preferred shares have already lost half their value since June 30 on speculation that an intervention would mean a stop in dividend payments (highly likely) and issuance of new preferred that would take preference over current preferred.

Interestingly, this would put more pressure on the banking system, as many banks hold the GSE preferred shares as assets, choosing to get a little extra return over traditional and more conservative assets. But then of course, Fannie and Freddie preferred were considered safe just a few months ago, with the best ratings from Moody's.

"Regional banks including Midwest Bank Holdings Inc., Sovereign Bancorp and Frontier Financial Corp., may have the most to lose. Melrose Park, Illinois-based Midwest has $67.5 million, or as much as 23 percent of its risk-weighted assets, in the preferred stock, while Philadelphia-based Sovereign owns about $623 million and Everett, Washington-based Frontier about $5 million." (Bloomberg)

It is doubtful that banks which hold these assets have written them down yet, but with a downgrade they will almost certainly be forced to do so in the near future. For the record, Fannie Mae has 17 classes of preferred stock, with more than 600 million shares outstanding. Freddie Mac has 24 classes of preferred stock, with about 460 million shares outstanding. The existing shares are trading worse than junk bonds, paying 17-19%.

And it may be a total write-off. It is hard to imagine how Treasury Secretary Paulson, or a new Treasury Secretary next year, could put US taxpayer money into the companies at risk without wiping out the current common and preferred shareholders. The justified outrage would be huge.

The basic problem is that without Freddie and Fannie the US mortgage market would go from crippled to moribund, if not dead. We have created a system that could not function in the short term without them, and the pain of allowing them to collapse would be another 1930s-style Depression, the era in which these firms were first created. They were never designed to take on the huge leverage they did, or to use hundreds of millions in lobbyist money and campaign contributions to create a massive payment scheme for management and shareholders. Congressional estimates are that this could cost US taxpayers $25 billion, a significant multiple of their current market caps.

Fannie and Freddie will not be able to raise capital on their own. At this point, why would any rational investor put that much money into a company with such a convoluted preferred share scheme, without government guarantees? That estimated loss assumes that the housing market does not get worse from this point. Losses could be much worse, or things could get better. Who knows? Why invest in something with so much uncertainty?

But there are more problems. You can't just take someone else's property, and that is what stock is, without some serious reasons. You almost are forced to wait for a crisis, otherwise shareholders would sue, saying that they suffered unnecessary losses. You can certainly expect the preferred shareholders to sue. That is why Paulson hired JP Morgan to figure out how to recapitalize the banks. I don't envy the people who are working on that one. Maybe there is some magic somewhere, but as we saw with Bear Stearns, at the end of the day it is all about adequate capital.

The GSE companies should be adequately capitalized and broken up into much smaller firms that would not be too big too fail in the future, and put under a regulator that would enforce reasonable leverage limits, with the profits going to pay back the US taxpayer before any profits or dividends are paid to any other future owners.

That is, if the government takes the two GSEs and puts capital (probably in the form of loans and guarantees) into them, which puts taxpayers at risk, then allows a public offering of the smaller entities to raise capital to repay the loans, any shortfall should be made up by the issuance of preferred shares, and the common shareowners would wait until the government loan was repaid before they would be eligible for a dividend.

And the people responsible for creating the leveraged systems, the board, et al., should be forced to resign. New top management all around.

The ultimate goal should be for taxpayers to get their money back and any guarantee, implicit or explicit, to be removed. No mortgage bank should ever again be allowed to be too big too fail.

Now, taken as a part of the total credit crisis, which will run to over $1 trillion (at least), $25 billion may not seem like a lot. But I hope this is a wake-up call for better regulations and safeguards.

And before I go, let me reiterate my call for regulators to force banks to move their credit default swaps to an exchange. The potential for a blow-up is serious, and it could dwarf the current credit crisis. I am not saying it will happen, just that it could. Even a low-risk event should be protected against. Credit default swaps are legitimate business transactions. They are very useful. They should just be put on an exchange, like futures or options, where there is 100% transparency as to counterparty risk.

Baltimore, La Jolla, and South Africa

I am home for a few weeks, enjoying the tail end of summer. On September 6, Tiffani and I will head to Baltimore to be with Bill Bonner, founder of Agora Publishing, and a host of friends, to celebrate his 60th birthday. It is hard to believe that we have known each other for 26 years. What an incredible business model he has created. He has adapted with the times, letting his business evolve into a multi-hundred-million-dollar enterprise. I remember first going to his offices in Baltimore, which were definitely in a very bad part of town. I was nervous just walking two blocks in broad daylight; but the offices were inexpensive, I suppose.

He is the one of the best pure writers I know. You can read some of his essays and subscribe to the free *Daily Reckoning* (be warned: Bill is quite bearish) by clicking on this link: http://www.dailyreckoning.com/rpt/mauldin.html.

Tiffani and I will then be going to La Jolla September 15 to meet with my partners at Altegris, and meet some new potential associates. Right now, drinks with Richard and Faye Russell is on the calendar, and I really look forward to it.

Then a few weeks later I will head off on a quick trip to South Africa, where I will be speaking for an investment group in Cape Town, then maybe stop off in London for a day and then hurry home in time to do my regular letter.

That is enough to make me tired, so I think I will hit the send button and go home and see who is there. Have a great week.

Your needing to seek my own balance analyst,

John Mauldin