59 of 825 DOCUMENTS

The Economist

January 24, 2009
U.S. Edition

Shorn bank shares, shaven poll ratings, shredded nerves; Rescuing banks

SECTION: BRITAIN

LENGTH: 988 words

HIGHLIGHT: Britain's latest banking-rescue plan

Plan B gets off to a bad start

THREE months ago the British government led the world with its emergency measures to stave off a wholesale collapse of the financial system. As other countries adopted the same policy of recapitalising banks, Gordon Brown's reputation was burnished and his poll ratings enjoyed a startling bounce.

But if the prime minister was hoping to get another political lift this week as he announced a fresh initiative to help Britain's banks, he must have been disappointed. Their share prices turned to stone (see chart)--thanks partly to the expiry on January 16th of the ban on short-selling financial stocks--and sterling was battered as dealers worried about cross-infection between ailing banks and a sick economy.

The Treasury's new measures were wide-ranging. The Bank of England will set up a £50 billion ($69 billion) facility to buy private-sector assets such as corporate bonds and commercial paper. This will create a framework within which the central bank can conduct "quantitative easing"--creating money to buy assets--if that proves necessary. Northern Rock, a nationalised mortgage lender, will no longer seek to slash its mortgage book. The government will also encourage more lending by guaranteeing up to £50 billion in asset-backed securities. The Financial Services Authority helpfully said that the new capital recently injected into banks should be used both to withstand losses and to continue lending--though its chairman, Lord Turner, gave warning that in future banks would have to build up more capital in good times to prepare for bad times.

The heart of the Treasury's package was an "asset-protection scheme", a euphemism for dealing with the dodgy loans and assets that continue to hinder a return to banking health. Rather than setting up a "**bad bank**" to take these toxic assets off the banks' balance-sheets, the Treasury has decided to turn itself, in effect, into a catastrophe insurer. In return for paying a premium--and carrying the first chunk of any loss--banks will pass the buck for 90% of any further write-down to taxpayers.

Whatever the merits of this scheme in principle, clarity about how it would work in practice is not one of them. Specific information on the mechanics of the plan was sparse. This rattled the markets because it allowed unsettling speculation as to how big a bill might eventually be presented to the government and taxpayers.

The need for some scheme to detoxify banks' balance-sheets was underlined by this week's thudding results from Royal Bank of Scotland (RBS), in which the government has a majority shareholding. RBS announced an expected loss of up to £28 billion, the biggest in British corporate history. Much of this consisted of accounting write-downs of goodwill, resulting from the bank's disastrous participation in the 2007 takeover of ABN Amro, a Dutch bank, but it also included a loss of £7 billion-8 billion in 2008.

More important still, something must be done to deal with the credit drought. Banks have cut overdraft facilities and unused credit lines, withdrawn from lending syndicates and abruptly called in loans. When they do lend, they are charging higher arrangement fees and interest at margins over their cost of funding that are considerably higher than they were.

Britain's economy needs its home-grown banks more than ever. Foreign lenders have largely left the British market. Investors of all sorts are frightened of securitised debt and anything in sterling. Banks in other countries, including America, Germany and Switzerland, are also reluctant to lend. But their national banking systems are less centralised than Britain's, where the choice of banks is growing ever more concentrated among a small group of relatively homogeneous institutions.

As the new rescue plan has attracted brickbats rather than plaudits, pressure is growing for the government to go the whole hog and nationalise the banks in which it has such a big stake. That would mark a u-turn. UK Financial Investments, the agency set up to run the government's shareholdings in the banks the state has taken over so far--Northern Rock, the asset book of Bradford & Bingley (both mortgage banks), 70% of RBS and 43% of Lloyds (the recently-merged Lloyds TSB and HBOS)--has been told to do its job at arm's length. Influential Labour MPs such as John McFall, the chairman of the parliamentary Treasury committee, are now calling for the full nationalisation of RBS and Lloyds.

But this debate, though it is pushing down share prices, misses the point. The crucial question is whether the insurance scheme should complement a more ambitious "**bad bank**" into which lenders' duff assets could be dumped. Such an approach would have the merit of clearly valuing and isolating them, thus freeing banks to move on. The insurance plan could then be deployed to encourage new loans by promising that, were a worsening economy to push them underwater, the government would share the pain.

And more pain there will surely be, as the unremitting drizzle of depressing economic news this week made clear. The number of people claiming unemployment benefit increased by 77,900 in December. The jobless rate, using a broader definition of those looking for work, rose to 6.1% of the labour force.

The public finances also deteriorated sharply as some of the costs of the recent banking rescues came into the official figures. Excluding the banking bail-outs, public-sector net debt now stands at 40.4% of GDP; if they are included, it is 47.5%. Borrowing has continued to balloon.

Yet Britain's starting-point was one of relatively low debt, at least compared with the other big G7 economies. Standard & Poor's, a credit-rating agency, reaffirmed on January 13th Britain's cherished AAA rating on its sovereign debt. For all the market jitters, the government retains the capacity to finance more bail-outs--which is handy, since it will certainly need to do so.

LOAD-DATE: January 22, 2009

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

The Economist

January 24, 2009
U.S. Edition

The spectre of nationalisation; Economics focus

SECTION: FINANCE & ECONOMICS

LENGTH: 1016 words

HIGHLIGHT: How to make **bad banks** work

There are ways for governments to revitalise banks without taking them over

IT IS generally easier to remove a kidney from a dead donor than a live one. When regulators in Scandinavia and America in the early 1990s started extracting the bad assets from their crisis-hit banking systems, it helped that the banks they dealt with were bust or in the government's hands. Today, policymakers are trying to excise toxic assets from banks that are still, at least officially, private and viable. That is a much trickier proposition.

Last autumn, governments around the world poured new capital into private banks and guaranteed their debts to protect them from further losses and help them raise private capital. But continued losses have overwhelmed those initial efforts. Some banks have needed more capital, and a few have been nationalised outright. Moreover, the haphazard implementation of rescues has kept private capital on the sidelines, fearful of being diluted or wiped out. What is needed, the experts say, is a more systematic approach through the creation of a "**bad bank**" to assume the bad assets, leaving "good banks" to resume lending. (In an Orwellian attempt to hide the nastiness, it may be known in America as an "aggregator bank".)

The good bank/**bad bank** terminology dates at least back to 1988 when America's Mellon Bank spun off its bad energy and property loans into Grant Street National Bank, which was financed with junk bonds and private equity. Such purely private solutions are not feasible during crises that encompass the entire banking system: there is not enough private capital around. In the early 1990s the governments of Sweden and Finland each nationalised some of their largest banks and set up "**bad banks**" to dispose of their assets. Around the same time, America created the Resolution Trust Corporation to sell off the loans and underlying collateral of hundreds of failed savings banks, or thrifts. In each case, the assets taken over by the **bad bank** were equal to about 8% of GDP, according to a study by Daniela Klingebiel of the World Bank.

In this crisis policymakers have adopted piecemeal elements of the good bank/**bad bank.** In October UBS spun $60 billion of toxic assets into a fund backed by the Swiss central bank. America will absorb most of the losses on $306 billion of problem assets at Citigroup and $118 billion at Bank of America. It is also creating a facility, supported by the Federal Reserve, for asset-backed securities which could relieve banks of bad loans. Britain may insure banks against future losses. Like a **bad bank,** the aim is to isolate toxic assets, encourage private money to come in and discourage banks from hoarding their capital. But no market value has been put on them (although loss-sharing agreements in part serve that purpose). This spares banks from immediately recognising their losses, but it leaves a fog of uncertainty over the system. Banks will not boost lending if they fear that future loan losses will eat through the rest of their capital.

A **bad bank** could alleviate these concerns by convincing both banks and investors that the problem assets have either been removed from the banking system or will be as they surface. Paul Miller of Friedman Billings Ramsey, an investment bank, says a government **bad bank** can pay more for assets than a private investor because its cost of funds is irrelevant, it needs no capital and can hold the assets to maturity. It could also develop a professional and uniform approach to valuing and disposing of bad assets while leaving new lending decisions to the good banks.

But a **bad bank** faces different problems, the most serious of which is setting a price for assets that both it and the seller can agree on. This was less of an issue in the early 1990s, since the assets for the most part came from banks that had already failed or were under government control. Today, if the **bad bank** pays above the fair-market value, it would raise the cost to taxpayers, imperil its political legitimacy, and deprive the market of badly needed transparency. If it pays fair value or less, banks might be reluctant to participate. Those that did may have to recognise large, immediate losses, depleting their capital. As a result, setting up a **bad bank** would entail additional capital injections. To reassure itself that the recipient bank can survive, the government would invest only if the bank can simultaneously raise funds from private investors. Any bank unable to raise private capital, perhaps rendering it insolvent, would be taken over.

But such steps would be time-consuming and could be hit by a loss of market confidence at any moment. America abandoned its original plan to buy toxic assets last October in favour of extra capital because the crisis demanded faster action.

An alternative (or perhaps prelude) to a **bad bank** would be nationalisation. This would at a stroke end the tension between the goals of private shareholders who want to hoard capital and lend less, and government overseers who want banks to lend more and modify mortgages of homeowners facing foreclosure.

But nationalisation carries huge costs of its own. With the world awash in unwanted bank assets, it could take years for the governments to privatise their banks. Meanwhile politicians would be tempted to turn banks into instruments of industrial policy, propping up politically powerful industries such as carmakers and scrimping on more deserving recipients. Politically motivated lending could result in even larger loan losses in the future, and private banks would be put at a disadvantage. At the other extreme, governments might be so fearful of taxpayer losses that they lend even less than their private counterparts.

Economists have long recognised that banks are special. Through decades-old relationships with millions of households and businesses, they normally (though, sadly, not recently) steer savings to productive and lucrative endeavours. Letting banks collapse would wipe out this critical mechanism; nationalising them could, eventually, do it similar damage.

LOAD-DATE: January 22, 2009

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

61 of 825 DOCUMENTS

The Economist

January 24, 2009
U.S. Edition

Inside the banks

SECTION: LEADER

LENGTH: 1438 words

Blank cheques, bankruptcy, nationalisation: the options are dire, but governments must choose between them

"STARTING today," President Barack Obama declared in his inaugural address from the Capitol, "we must pick ourselves up, dust ourselves off, and begin again the work of remaking America." In fact his first, urgent task is to remake finance. As Mr Obama spoke in Washington, DC, the markets in New York were sinking under the weight of failing banks despite the promise of a plan from his economic team. A day earlier Britain had put forward its second attempt to get its banks to lend. Others, such as Germany and Italy, may before long need to step in; France, Ireland and Denmark already have.

The crisis has shown up flaws in financial markets and the global economy. Huge flows of capital into debtor nations like America and Britain pumped up asset markets (see pages

). These fed the instabilities of financial markets--which, as our special report explains in this issue, were themselves plagued by poor regulation, dangerous incentives and the reckless use of mathematical models. Fixing this will take a lot of work over the next 18 months or so, when legislation should be ready, but already a picture of a new finance is becoming clearer: smaller, better regulated, more conservative.

That vision is worth keeping an eye on, but the immediate priority is the imperilled banking system. Just now, with finance in ruins, the nexus of markets and non-banks that make up the "shadow banking system" has failed. Decent businesses are being starved of credit and driven into bankruptcy. For their sake, and for the people who work for them, it is time to admit that the first round of bank rescues was not enough. With talk of huge public subsidies--nationalisation even--the question is what to do next?

Nothing at all is one answer. Because last year's efforts cost hundreds of billions of dollars, some may conclude that saving the banks is wasteful and pointless. In fact the first rescue succeeded in one important respect. The excessive lending of the boom has to be brought under control. That inevitably brutal change can take place in two ways. It could be relatively orderly as borrowers scale back and lenders strengthen their balance sheets. Or it could cause a mass-panic that would wreck banks and businesses as it did in the 1930s. Just such a panic was in the air in October. Today's recession is grave but in sparing the banks, however undeserving, governments spared their citizens from something worse--at least so far.

If a rescue makes sense, what sort? Last autumn the rescue of Britain's banks--perhaps the sorriest in any large economy--became a template for others. Britain is in the lead once more, but this time round its effort is likely to be remembered for all the wrong reasons. The main part of the government's new plans is to insure the banks against their worst losses on their worst assets. Nobody (not even the government) knows how much that will cost; just that Gordon Brown has once again thrown all his ideas at the problem, including the kitchen sink.

The prime minister should do his bit for the building trade and order a bigger sink. The markets were unimpressed by the scale of his effort. Shares in London fell, notably in the very banks the plan was designed to help. Sterling tumbled on fears for Britain's economy and the government's finances.

For any government setting out a rescue, this reception holds two lessons, concerning the scale and the shape of a rescue. First, its scale must surprise everyone. Because economies everywhere are suffering from excessive fear as well as over-borrowing, part of the aim is to convince investors that the downward spiral in confidence has been broken. Britain's plans were caught in a contradiction: seeking both to save the banks, which need a staggering sum, and also to mollify voters, who (understandably) resent handing over a single penny.

Scale is important in this crisis. As the recession rips through the economy, banks are bound to face further losses. Shareholders worry that these losses will continue to eat away at the banks' reserves. Back in October governments' promises to save the banks stabilised markets. But in this topsy-turvy crisis these promises are now pressing down on banks' share prices. If a bank looks about to suffer large losses, investors fear nationalisation is imminent--and head for the exit.

And that leads to the second broad lesson from Britain: the design of a rescue matters and history shows that it is hard to get right (see

). One possibility is government guarantees and insurance. Another is to take the hit up front, by putting the toxic assets into a "**bad bank**" that acts as a cordon sanitaire. And a third, which has been gaining traction of late, is outright nationalisation.

Each of the three has its strengths. Guarantees can quickly swing into action and the assets remain with managers who know most about them. **Bad banks** create a clean break that enables the good bank left behind to get on with the real job of raising capital and lending it out. Even nationalisation has something to say for it. Gone are the difficulties of valuing assets and of the bank's shareholders plotting to grab taxpayers' money--because the government is on both sides of the deal. Expect to hear that argument a lot more over the coming months, not just in Europe but also in America.

As a capitalist newspaper, we reject a deliberate policy of wholesale nationalisation. To be sure, state ownership may make some sense as a tactic for specific financial institutions. We argued for it with both Fannie Mae and Freddie Mac in the United States and with Northern Rock in Britain long before politicians in either country succumbed to the inevitable. Like it or not, it may be the least bad option in many cases ahead. But the difficulties are legion. Unless nationalisation takes place at market prices, it undermines property rights and raises the long-term cost of capital. And even if expropriation is avoided, there are difficulties. Although nationalised banks could increase the supply of credit by restoring confidence, their record at allocating it is even worse than private banks'. If the idea is state-directed lending, the banks will waste a fortune and kill enterprise. If the plan is to offer the banks a brief shelter in a storm, it looks fanciful. Large bank privatisations are unlikely for several years.

But what of the other two options--**bad banks** and insurance? Britain chose insurance alone and, at the moment, it looks as if it has made a mistake. The suspicion is that the government preferred insurance for political reasons because it is a promise-now, pay-later scheme. It would have done better to reach for that kitchen sink and do both--buy the worst assets at their market value and put them in a **bad bank,** as well as insure the healthy assets that remain against catastrophe. With a clean start, the remaining good banks would be able to raise capital. The idea would be to examine each bank on its merits, cleaning it out, partially insuring its remaining risks, and recapitalising it with government equity where necessary. At some banks that might leave the government as the biggest shareholder, as the British government is at the Royal Bank of Scotland, or the sole owner, as at Northern Rock. In such cases nationalisation is not an end in itself, but a consequence of the policy that most rapidly returns the banking system to health. It is a heavy cost, but there is no alternative. If taxpayers own a bank, pretending that they don't only exacerbates the harm.

This crisis is so huge that seeing beyond it is hard. Yet even now policymakers need to plan for the future of finance--partly to convince voters that today's rescue is preparing for a better system; partly because finance's shortcomings and the taxpayers' guarantees make an overhaul of regulation necessary; and partly because sensible reforms are hard to devise.

Having seen finance wreak havoc, the temptation will be to bind it in a regulatory straitjacket. Some tighter regulation is in order, especially if it is aimed at making the system more transparent. But this crisis was born of economic excess as well as financial folly; given the torrent of capital flowing into America, Britain, Spain and so on, almost any financial system would have gone wrong. Financial re-regulation is not the only reform--it may not even be the most important. Yet finance makes the rest of the economy work. Mr Obama's prize for remaking finance will be measured in prosperity and jobs. The work should begin now.

LOAD-DATE: January 22, 2009

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

228 of 825 DOCUMENTS

The Economist

January 17, 2009
U.S. Edition

A gallant effort;
Getting banks to lend

SECTION: BRITAIN

LENGTH: 766 words

HIGHLIGHT: A plan to unfreeze bank lending

A business plan that misreads the banks' dilemma

LORD MANDELSON, the business secretary, has long complained that credit-crunched banks are not lending enough to small and middling businesses. His earlier efforts to find credit for small firms (£1 billion--$1.46 billion--of help for small exporters and the like) were clearly not enough: companies are going bust and shedding jobs with increasing frequency. So on January 14th his Department for Business, Enterprise and Regulatory Reform (BERR) launched another gallant attempt to get more credit flowing.

Under BERR's new scheme, the government will guarantee 50% of up to £20 billion-worth of bank loans to companies with less than £500m in annual turnover. Bankers will keep the job of assessing credit, proffering to the government portfolios of qualifying loans (mainly short-term support for working capital to keep firms ticking over). In exchange for the guarantee, banks are to pay a premium and promise to lend money to other firms to which they would not otherwise have extended credit. Smaller schemes will be set up too: in one, the government will guarantee three-quarters of the financing for £1.3 billion in small-company loans; in another it will provide two-thirds of a £75m fund co-sponsored by banks to swap debt for equity in small firms. Lord Mandelson says he will return to the attack to assist big companies and ease credit insurance, which helps firms maintain their supply chains.

This is well-intentioned stuff. Companies big and small are being starved of bank credit, and this is having dire consequences for businesses and the economy in general. About 84 businesses are going bust each day, compared with around 65 in happier times, according to BDO Stoy Hayward, an accounting firm. More than one-third of firms in a sample of British companies polled in December by Roland Berger, a consultancy, said that banks had cut their unused credit lines over the past year (see chart).

But Lord Mandelson's plan has two problems. First, it may not be workable. Banks reluctant to lend will pay a premium for insuring their lending only if the fee is minimal, which offers the taxpayer little protection; and officials will have trouble discerning whether banks' "other" lending was truly not contemplated.

More important, the plan misreads the nature of the banks' dilemma: the parlous state of their balance-sheets, despite the billions of taxpayers' money already poured into them. The Basel 2 international bank-capital regime and the global accounting standards known as IFRS--to say nothing of security analysts and rating agencies--are forcing banks to hoard more capital, anticipating that deepening recession will slash asset values further. This amplifies an already appalling business cycle: together, Basel 2 and IFRS are "like procyclicality on speed", says Brandon Davies, a risk consultant. To maintain capital ratios, banks can either try to raise more money or cut lending. As stockmarkets are spectacularly unreceptive, most are choosing the latter course.

The lack of capital is particularly explosive at the moment because banks' annual financial statements are falling due. Bankers and regulators are haggling now with auditors about how to present their accounts. An auditor worried about whether a bank will be a going concern in 12 months' time may feel bound to write a cautioning paragraph, known as an "emphasis of matter". This could shake the public's already low faith in banks. Bank directors too must attest that they are running going concerns, and risk legal consequences if they are knowingly wrong.

Various ways to relieve the banks' lack of capital and get them lending again were suggested at a parliamentary committee hearing on January 13th, echoing urgent debate elsewhere. Nationalisation came up--but few regard the government as a good allocator of capital. Another suggestion was to relieve banks of some of their worst assets and put them in a so-called **bad bank,** as Swedish and Mexican banking authorities did in previous banking crises. "The state is the only one that can take this on and perhaps make money out of it," the committee heard. A **bad bank** would need to mop up nonperforming and deteriorating corporate and property loans totalling about £260 billion, calculates JPMorgan, a bank, stumping up £53 billion to support the risky assets or siphoning off deposits along with them.

In the longer term, some bank experts would like to see capital-adequacy and accounting rules made more countercyclical. But companies strapped for cash today can hardly hang on for that solution.

LOAD-DATE: January 15, 2009

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

229 of 825 DOCUMENTS

The Economist

January 17, 2009
U.S. Edition

A house built on Sandy; Citigroup

SECTION: FINANCE & ECONOMICS

LENGTH: 1101 words

HIGHLIGHT: Citigroup's about-turn

And the rain descended, and the floods came, and the winds blew, and beat upon that house; and it fell: and great was the fall of it

"TOO big to fail, too shit to buy" is the way some Citigroup insiders describe their employer. Not for much longer. On January 13th Citigroup announced that it had reached a deal to spin out Smith Barney, its broking arm, into a joint venture with Morgan Stanley's broker. The agreement presages even more dramatic changes. The bank has brought forward its fourth-quarter results to January 16th and expectations are high that Vikram Pandit, Citi's chief executive, will unveil plans to slim the bank further and faster.

The Smith Barney deal is already a watershed. As recently as November, Mr Pandit heaped praise on the broker and said he did not want to sell it. No wonder. Citi's wealth-management business, of which Smith Barney is a big part, was the only one of its main divisions to post a profit in the third quarter. And it sat snugly with Citi's universal-bank model, endorsed by Mr Pandit just weeks ago, of offering a full array of services to customers.

Citi will still receive its share of revenue from the joint venture, which overtakes the troubled Bank of America-Merrill Lynch combination as the world's largest broker by number of advisers, but there is no question who will be in charge. Morgan Stanley is paying Citi $2.7 billion to take a 51% stake in the venture, which will be called Morgan Stanley Smith Barney, and has an option to take further stakes. James Gorman, now seen as favourite eventually to succeed John Mack as Morgan Stanley's boss, will be the venture's chairman.

Mr Pandit's about-face reflects Citi's continuing need for capital. Those quarterly results are expected to be the fifth in a row where Citi bosses own up to a loss. Although the bank has received two shots of government money and has a decent level of capital by some measures, its first line of defence, common equity, is thin. Mounting problems in its consumer and corporate loans, as well as some old wounds in its portfolio of mortgage-backed securities, threaten to erode it further. Selling Smith Barney, which creates tangible common equity of approximately $6.5 billion, is the quickest way of plugging the gap.

Gap-plugging alone does not constitute a strategy. Initial word of the deal sent Citi's share price skidding on January 12th, as investors reasoned that the bank must be desperate if it was choosing to sell one of its best assets. Hence reports that more radical surgery is coming, with up to one-third of the bank's assets being hived off to leave a slimmer Citi, focused on global corporate and retail banking.

Precisely what Mr Pandit has in mind is not clear, but it may be too late for an elegant retreat. Many of the businesses he would like to unload, such as Primerica, a seller of insurance, have been on the chopping-block for a while. Appetite will probably be keenest for the things that Citi would most like to keep--its retail-banking operations in Mexico and South Korea, say, or its suddenly sexy transaction-processing business. There is talk of setting up a separate entity to house the assets earmarked for sale, which could then be divested later. But that would still leave Citi with the problem of how to fill today's holes in its capital.

Citi's burst of activity signals two big, and necessary, shifts in thinking. The first is the final abandonment of the idea that has animated Citigroup since Sandy Weill engineered the merger of his company, Travelers, with Citicorp in 1998--that of the financial supermarket. The news on January 9th that Robert Rubin, a powerful voice in favour of the universal model, is to quit the board affirms the change. (The position of Sir Win Bischoff, the bank's chairman, is also reportedly under discussion; Mr Pandit looks more secure, if only because no one wants his job.)

Universal banking need not fail. But smaller, focused organisations are easier to run than large, sprawling ones--Citigroup has more employees than the American navy and, apparently, greater destructive power. Mr Weill's creation, backed by a host of executives, directors and investors ever since, has proved horribly flawed. Unlike HSBC, another giant, Citi has been built through deal making and it shows. Acquisitions were poorly integrated. Cultures overlapped rather than melded (the resilience of the Smith Barney name is one telling indicator). Risk management was dismal. The big balance-sheet was deployed recklessly. It may be inevitable that some banks are too big to fail; but the lesson of Citi is that they can also be too big to manage.

The second shift in thinking signalled by Citi's manoeuvres concerns policy. November's dramatic government intervention may have quelled fears that the bank would go under. But it has not stopped the bleeding at Citi, which remains focused on survival rather than on ramping up credit. Red ink laps around a host of other banks too. Full-year earnings at American banks are likely to be awful. Many eyes are on Bank of America, whose levels of tangible equity are also thin and, with Merrill Lynch and Countrywide to digest, is seeking billions of dollars in additional capital from the government. In Europe Deutsche Bank revealed a fourth-quarter loss of ?4.8 billion ($6.3 billion) on January 14th, thanks in part to misplaced trading bets.

Recognition is growing that bad assets must somehow be purged from banks' balance-sheets before they will freely make new loans. Citi has already had more than $300 billion of toxic assets ringfenced and guaranteed by the government; its apparent intention to create a separate entity for its unwanted assets is a more straightforward echo of the "good bank/**bad bank**" approach used in Sweden's much-vaunted bail-out of the 1990s. In a speech on January 13th Ben Bernanke, chairman of the Federal Reserve, pointedly highlighted the continuing need for the financial system to shed its toxic assets.

That was the original purpose of the $700 billion Troubled Asset Relief Programme (TARP), approved in October, an effort that largely foundered on the difficulties of setting a purchase price for bad assets. The valuation problem has not gone away. Given the further deterioration in markets since the autumn, few believe that the $350 billion still left to spend from the TARP, if Congress agrees to release it, is anywhere near enough to absorb all the poison in the system. Even so, Citi's shift in direction may signal that policymakers are looking again at the idea of **bad banks.** After all, one U-turn deserves another.

LOAD-DATE: January 15, 2009

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

The Economist

January 3, 2009
U.S. Edition

Return to wealth;
Bank strategy

SECTION: FINANCE & ECONOMICS

LENGTH: 927 words

DATELINE: zurich

HIGHLIGHT: UBS plots its future

UBS has had a terrible crisis. That may help it have a better aftermath

"FAIL fast, fail early" is a management mantra in many industries. Identify the projects that will not pay off quickly, and the costs of failure are capped. Banks have developed their own version of this rule--"fail completely, fail catastrophically"--but one of the earliest victims of the crisis may yet be among the first to recover.

UBS was one of the first to feel the effects of America's subprime meltdown. That had some advantages. The Swiss bank started raising capital while private money was still available (although it has since had to call on government help). It installed a new leadership team relatively early. And it cut staff numbers hard, which will help during chilly times ahead.

True, UBS is also fortunate in not having big loan books to drag it down as the real economy sinks. That helps to explain why the bank's share price has outperformed an index of European banks over the past four months (see chart). But it has taken other steps which may point the way forward for the rest of the industry.

Start with the state of its balance-sheet, which is now cleaner than those of most of its investment-banking peers. The bank got a huge helping-hand from the Swiss central bank, which agreed in October to house up to $60 billion of UBS's bad assets in a separate entity. Analysts at Morgan Stanley reckon that UBS now has the lowest ratio of problem assets to tangible common equity, a particularly pure measure of capital, of any of the big European and American wholesale banks. The idea of the "**bad bank**" may yet win more traction elsewhere because of the UBS example.

UBS has done more than spruce up its books. It has also shrunk them. The value of its assets has come down by a whopping SFr590 billion ($550 billion) since the second quarter of 2007. Most of that reduction has come not from write-downs or asset transfers but from running off short-term trading assets. UBS is already pretty close to meeting the 3% leverage ratio initially imposed upon it (and Credit Suisse) by the Swiss authorities. The people who run banks used to crow about growth in assets; now they plot their reduction.

These changes do not protect UBS from harm. The bank retains a significant gross position in leveraged loans, for example, and hedging is difficult for everyone when markets are so volatile. Despite the reduction in assets, the bank remains leveraged to a huge degree. Its balance-sheet at the end of the third quarter was still $2 trillion. Marcel Rohner, the bank's chief executive, gives warning against reading too much into the volume of nominal assets. Buy a share and sell a call option on that same share, he says, and your balance-sheet has grown but your risk has not.

Maybe so, but investors are right to question the ability of banks to judge risks precisely. That lack of certainty extends within UBS, which promises to become a more humble institution as well as a smaller one. The bank has made several changes to its governance under the guidance of Peter Kurer, its chairman.

A self-excoriating review of the bank's failures of risk management in April was followed by the abolition of the chairman's office, a power centre developed under Marcel Ospel, Mr Kurer's immediate predecessor. The upshot has been much greater contact between outside board members and executives than before.

The bank is also in the process of separating into three autonomous units: wealth management, investment banking and asset management. Central to this reorganisation is an overhaul of the bank's internal funding mechanisms--many of UBS's problems lay in absurdly cheap financing for its investment bank. Such reforms do not impress everyone. "It just brings UBS out of the dunce's corner," says an analyst. But other changes are more pioneering. In November, UBS unveiled a new set of pay policies that included the idea of a "malus", or negative bonus, a way of clawing back deferred compensation in the event of poor performance.

Importantly, the reorganisation has also made it clearer what UBS is for. The bank has affirmed the importance of its market-leading wealth-management arm as its main franchise. That was not always the case. "It was less clear under Ospel that wealth management was the core business," says a former UBS executive.

The investment bank is ditching proprietary trading and concentrating on client-focused activities: "We will end the blurring between risk-takers and flow businesses that we have seen in past years," says Mr Kurer. It is also zeroing in on areas where it has particular strengths, such as equities and foreign-exchange trading. That marks a shift. UBS's disastrous foray into mortgage-backed securities aimed to close the gap in areas where it lagged. The revamped bank will not try to compete in every market, although that is easier said than done given client demands. "The unanswered question is whether you can be a good golfer with only three clubs," says Jeremy Sigee of Citigroup.

UBS is nowhere near being out of the woods. The biggest uncertainty it faces is the extent of the reputational damage that its wealth-management business has suffered. But if UBS can stanch the outflows that it started to see in the second quarter of 2008, and reach a deal with the American authorities in their investigation into its offshore services, it may soon dare to think about future success. Come what may, its efforts to become a smaller, less cocksure and more focused bank chart a route to recovery for many others.

LOAD-DATE: January 3, 2009

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

The Economist

November 29, 2008
U.S. Edition

Stockholm syndrome;
Bank bail-outs

SECTION: FINANCE & ECONOMICS

LENGTH: 354 words

HIGHLIGHT: **Bad banks** briefly explained

Bad banks were a big part of Sweden's 1990s rescue package

"US OLD guys are really being dusted off at the moment," jokes one architect of Sweden's successful bank bail-out in the early 1990s. Maybe so, but policymakers, particularly in America, are still taking an age to learn their Swedish lessons. The country took a comprehensive approach to its crisis, not only guaranteeing debts and injecting government cash into banks that could not raise private capital, but also setting up "**bad banks**" to manage institutions' toxic assets. The Citigroup rescue edged in this direction; UBS is setting up a **bad bank** with Swiss government money. But there is further to go.

The idea of a **bad bank,** a separate entity which takes ownership of non-performing assets and then manages them in order to maximise their value, is simple enough. The Swedes set up two **bad banks** (with the reassuringly solid names of "Securum" and "Retriva") to handle the crummier assets of Nordbanken and Gota Bank, two nationalised institutions. And very effective they were (indeed, some borrowers complained they were too ruthless). Their efforts to restructure and sell distressed loans helped Sweden to keep the eventual cost of its bail-out below 2% of GDP.

One advantage of the **bad-bank** structure is neatness. Taking toxic assets off the balance-sheet leaves behind a cleaner bank which should find it easier to raise capital or attract buyers. Another is specialisation. According to Jonathan Macey, a professor at Yale University, the genius of the Swedish scheme was that it allowed people who were good at restructuring bad loans to focus on that job, and those who were better at running banks to concentrate their efforts there.

Things are more difficult today. The Swedish loans were much less complex than modern securitised assets. Pricing the assets was also easier because taxpayers were on both sides of the deal, owning both the nationalised good banks and the **bad banks.** Nor was the rescue a panacea: Swedish bank lending to the private sector contracted for years after the intervention. But ugly as they sound, **bad banks** are a good idea.

LOAD-DATE: November 27, 2008

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

400 of 825 DOCUMENTS

The Economist

November 29, 2008
U.S. Edition

Singing the blues;
Citigroup

SECTION: FINANCE & ECONOMICS

LENGTH: 1172 words

DATELINE: NEW YORK

HIGHLIGHT: Another vast, ad hoc bail-out

A flawed rescue keeps America's most iconic bank afloat. Now it must show it deserves to exist

WHEN Citigroup was formed a decade ago, in a merger that reshaped banking, the deal's architect, Sandy Weill, basked in the limelight and admitted to feeling like a rock star. The boss these days, Vikram Pandit, must feel more like a busker. Humbled by a devastating, Lehmanesque run on its shares, Citi has become the latest, and largest, financial institution to need rescuing. The giant bail-out gives the bank breathing space. But it also leaves Citi in what a prominent financier calls a "financial no-man's-land": still too leveraged for comfort and too cumbersome to manage effectively, yet far too big to fail.

The rescue comes in two parts: it provides $40 billion in fresh capital and capital relief, and it ring-fences $306 billion of illiquid assets on Citi's $2 trillion balance-sheet. The bulk of any losses on these, beyond the first $29 billion, will be borne by government agencies. One official describes the arrangement as "catastrophe insurance" for Citi. The deal, a new version of intervention in a crisis that has already seen a few, is the strongest sign yet that the government will do whatever it takes to maintain confidence in banks, says Torsten Slok, an economist at Deutsche Bank.

The immediate benefit is to reinstate Citi as a trusted trading partner: though there was no doubt it would be propped up, clients had begun to pull money. And the loss-sharing agreement leaves the bank with a substantial capital surplus, if (a big if) you trust the way it values its dodgier assets. But the plan, crafted in a hurry over a weekend, has several flaws.

First, no one has been forced to take responsibility for Citi's woes. Keeping Mr Pandit on was understandable: in the job for less than a year, he was dealt an awful hand. But the longer-serving board has plenty to answer for; and Robert Rubin, formerly head of its executive committee (and professionally close to both the outgoing and incoming treasury secretaries), encouraged its disastrous foray into collateralised-debt obligations. Shareholders also get an easy ride. Losing the dividend for three years is a small price to pay for not being all but wiped out, as has happened in previous rescues, such as that of American International Group, a giant insurer, and Fannie Mae and Freddie Mac, the two vast mortgage agencies.

Moreover, the deal marks a return to the patch-by-patch approach that preceded the $700 billion Troubled Asset Relief Programme, or TARP. This may have been unavoidable, given the ferocity of Citi's decline. But it sows uncertainty, just weeks after the government attempted to bring more coherence to its bail-out policy.

Third, it is not big enough to guarantee that Citi can avoid returning to the trough. The cloistered $306 billion includes the bank's most noxious holdings, such as mortgages, commercial-property loans and leveraged loans. But its huge credit-card and overseas-loan portfolios remain outside, and are degenerating fast. Nor are Citi's off-balance-sheet exposures--$1.2 trillion at the end of September--included.

Some facets of the deal look like smoke and mirrors. It releases $16 billion in regulatory capital to Citi, by giving a generous 20% risk-weighting to the partially insured assets (previously booked at 100%). As a result, it will have to hold a mere $5 billion of tier-one capital against 60 times that in questionable debt, on which it must bear the first $29 billion in losses.

Last, the rescue does nothing to establish a clearing price for the impaired assets on banks' books. This was the original aim of the TARP, using auctions, but it was dropped earlier this month in favour of direct capital injections. Officials would like to see Citi and others using their excess capital to buy securities cheaply in the secondary markets--in other words, to take on the role the government abandoned. For the time being, this is a vain hope.

Imperfect though it is, the rescue appears to have been designed to be used as a template for future interventions. "This is now the most effective way to show our commitment," insists an American financial regulator. It may also be expedient for the Treasury, which has only $20 billion left from the first $350 billion tranche of the TARP--Congress is yet to release the second half--since the new approach rests primarily on insurance, not hard cash.

But is it the right approach? Some would have preferred to see Citi hive off its troubled assets into a separate "**bad bank**", tasked with disposing of them in a way that minimised downward pressure on financial markets. This approach worked well in several past financial crises, including Sweden's in the 1990s (see story above). In this one, it has been used to unburden UBS of up to $60 billion of dross, which will be managed by the Swiss central bank.

In economic terms, the **bad bank** may be little different from the type of backstop used by Citi; in both cases, toxic holdings are isolated. But a **bad bank** may have a more positive psychological impact on markets, because it signals a clean break. It also removes a big distraction, allowing managers of the good bank to focus on the healthier businesses. On the other hand, **bad banks** can be difficult to set up in the thick of a crisis, when it is still unclear which assets should be transferred. And for the institution being helped, it reduces the potential upside, should values recover. Citi will reap gains from some of its walled-off assets as markets stabilise.

But that is for the distant future. For now, Citi's challenge is to regain its balance. Then it will have to prove that it has become less accident-prone. The bank has been heavily involved in most of the past quarter-century's nastiest blow-ups, from the sovereign-debt defaults of the 1980s to the dotcom bust. It was even temporarily banned from launching new takeovers in 2005, after a string of regulatory lapses. Built in a hurry by Mr Weill, the group that Mr Pandit inherited lacked a solid culture. Its risk management was not up to scratch. Its investment bank was a patchwork of acquired shops and poached teams. "It was the greatest roll-up in history, but it is yet to sing," admits a Citi executive.

The genial Mr Pandit is working on creating more harmony and tightening controls. He has also shaken up the way Citi allocates capital and pledged to cut staff numbers by 20% as part of a broader overhaul. He wants Citi to go back to doing "the basics"--retail banking, corporate services, merger advice--really well. That would seem to rule out a much talked about tie-up with Goldman Sachs, dubbed Sachs and the Citi.

But he has admitted he could have moved faster, and more dramatic action may now be needed. Though they have made no explicit demands, regulators want a slimmer, safer Citi. Shareholders want to see proof that the financial-supermarket model works, or else a break-up. For what is the point of a bank that is too big to fail but too unwieldy to succeed?

LOAD-DATE: November 27, 2008

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

401 of 825 DOCUMENTS

The Economist

November 29, 2008
U.S. Edition

The perils of incrementalism;
The world economy

SECTION: LEADER

LENGTH: 1320 words

Bold, unorthodox remedies are needed to jolt the world economy back to life

THE prognosis is looking ever more grave. What began 15 months ago with a seizure of the credit markets has become a disease with an alarming list of real economic symptoms. America, Britain, the euro zone and Japan are already in a recession that threatens to be the worst, in some places, for a quarter of a century and possibly since the Depression. American consumers, unable to borrow and fearful for their jobs, are cutting spending; so are firms, short of cash and worried about sales. German business confidence is at a 15-year low. Japan's exports to both rich countries and emerging ones are falling. Emerging economies are suffering too, as commodity prices fall and capital flees faster than in those countries' own crises of a decade ago. In some countries--notably the United States--a vicious deflationary spiral of banks withdrawing credit and demand contracting is no longer unimaginable.

Seeing the threat to the world economy's vital functions, the policymakers have been working overtime. Interest rates have been cut dramatically. American rates are already down to 1%; Britain's are at a 50-year low; and this week China's central bank lopped 108 basis points off its main policy rate. Hundreds of billions have been pumped into banks and financial markets. Many financial institutions have been bailed out: the rescue of the once mighty Citigroup (

) is merely the latest unthinkable to happen.

Despite all this, the patient has not responded. This is partly because some traditional remedies, such as looser monetary policy, are weakened in a credit crunch. It is also because the doctors have been ham-fisted: look at Hank Paulson's changes of mind about whether to use America's $700 billion rescue fund to recapitalise banks or to buy toxic assets. In addition, though, a lot of policy has been far too timid. Halting the world economy's decline will demand something rather bolder than anything seen so far in this crisis.

That means redoubling existing efforts in each of the three traditional areas of policy: bolstering banks; providing greater fiscal stimulus; and cutting interest rates. It also involves using more unorthodox tools, such as interfering directly in credit markets by buying up assets--a route where America's Federal Reserve has shown the most creativity. Indeed, such "quantitative easing" is an augury for the option to be tried in extremis: reflating the economy by printing money to finance budget deficits. That risks inflation, which is economic poison; but, in highly indebted countries, it is less murderous than deflation.

Mercifully, the world is not at that stage yet. But it is getting closer. One person who seems to understand the need for action on a bigger scale is Barack Obama. In his various press conferences this week America's president-elect laid out the nature of the challenge better than many leaders already in office. This was a "global crisis", he argued, which merited a "global response". The economy was "trapped in a vicious cycle" and needed a big "jolt" to ease the flow of credit and to cushion the drop in private demand. He is right.

The starting-point for many policymakers remains lowering interest rates. Central banks in some rich economies, in particular Britain and the euro zone, still have room to cut rates--though it is notable how even fairly dramatic cuts are not working as they once did. The Bank of England reduced rates by one and a half percentage points in one go this month. But with banks reluctant to lend, lower rates from central banks will not work miracles.

That suggests there is a lot to be gained in most places by concentrating more on the banks. The fact that Citigroup, the world's biggest bank not so long ago, needed a rushed weekend rescue was an indictment of the authorities' failures thus far, especially in America. Above all, Citi's collapse showed the dangers of leaving huge quantities of toxic assets to fester on banks' balance-sheets. Pumping in capital--as governments have been doing--is essential, but may not be enough. The history of successfully handled banking crises, such as Sweden's in the early 1990s, suggest that governments also need to remove bad assets from banks' balance sheets.

It would be good to report that the Citi deal provided a new model. Not really. The rescue is opaque--yet another ad hoc bail-out rather than part of a systematic plan; and it is too kind to the bank's management, board and shareholders. Granted, the rescue ring-fences and limits Citi's losses on a pile of the worst loans. But it would probably have been better to hive off its most toxic assets into a separate "**bad bank**".

Looking ahead, governments in rich countries will need to do more to help their banks on both fronts--injecting capital and buying up assets. That would mean admitting to the scale of the problem: America may need more than the $350 billion left in the Treasury's financial-rescue fund.

A more stable banking system will eventually get the money flowing, but in the meantime there are other ways. Intervening directly in credit markets makes a lot of sense in America, which relies more than other countries on non-bank finance and where official interest rates are hard to cut further. This is where the Fed has already been inventive: printing money to buy all manner of assets. In October it said it would buy short-term commercial paper. This week it unveiled two new schemes: a $600 billion plan to reduce mortgage rates by buying government-backed mortgage securities and the debt of America's state-sponsored mortgage giants; and a $200 billion scheme to buy the debt backed by credit-card, car, small-business and student loans (

). This approach could be broadened to other markets that have shut down. For instance, there is little fresh (senior) credit for firms in bankruptcy. If the government can provide that cash, it could stop the coming wave of bankruptcies from becoming one of corporate liquidations.

However, all the bank rescues, credit interventions and looser monetary policy will only get the world so far. The biggest part of Mr Obama's "jolt", as he made clear, must be fiscal. When private demand sags so dramatically, the public sector must step in to boost spending, and boldly enough to make a difference. In America, although Mr Obama has refused to give a figure, talk among Democrat bigwigs is of a fiscal boost worth $500 billion-700 billion, or 3-5% of GDP.

So far the only other big country to conjure up sums on this scale is China (and its huge stimulus keeps on having to be revised downward as the figures are checked). Some of the timidity in Europe is explicable: its generous welfare states have more "automatic stabilisers", such as payouts to unemployed workers, to support economies in recessions than hard-hearted America does. Even so, the Europeans have hardly impressed with their daring.

This week Britain's chancellor laid out tax cuts worth 1% of GDP, but coupled these with a counterproductive plan to raise income taxes on high earners later (see next leader). The European Commission has proposed a fiscal boost, across the European Union, of ?200 billion ($258 billion), or 1.5% of GDP, but its proposal seems unlikely to be taken up enthusiastically by member states. Germany, the EU's biggest country, has both the heft and the money to loosen budgetary policy. Yet the government's recent boost, amounting to just 0.25% of GDP, hardly suggested urgency.

Plainly, not all countries can afford precisely the same dose of fiscal stimulus. Those reliant on skittish foreign capital have less room to take action than those countries with large amounts of domestic saving. But cautious incrementalism, ironically, risks letting the world slip ever further down the deflationary spiral. It is time to follow Mr Obama's lead and jolt the patient back to life.

LOAD-DATE: November 27, 2008

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

752 of 825 DOCUMENTS

The Economist

January 26, 2008
U.S. Edition

Buddy, could you spare us $15 billion?; Bond insurers

SECTION: FINANCE & ECONOMICS

LENGTH: 1032 words

DATELINE: new york

Another shady realm of finance goes begging for a massive bail-out

THIS has been a crisis of risk in unexpected places. Think of collateralised-debt obligations (CDOs), structured investment vehicles (SIVs), and now a £4.9 billion ($7.1 billion) loss due to fraud at Société Générale. One particular nastiness has been festering in an obscure industry which, until recently, enjoyed pristine credit ratings: the "monoline" bond insurers. Their plummeting fortunes (see chart) helped to spark the stockmarket sell-off that prompted the Federal Reserve to act this week ahead of its scheduled meeting.

So perturbing was their plight that the prospect of a rescue caused a far bigger stockmarket rally than the Fed's biggest rate cut in a quarter of a century the day before. There may be no better example of how a dull province of finance, when snared by complex risks it barely understands, can become terrifyingly unboring.

Though themselves no giants, monolines have guaranteed a whopping $2.4 trillion of outstanding debt. The two largest, MBIA and Ambac, cut their teeth "wrapping" municipal bonds, in effect, renting their AAA rating to the securities for a fee. For a long time this business, though staid, was nicely profitable.

But, as competition grew, the monolines--with two honourable exceptions, FSA and Assured Guaranty--were seduced by the higher returns of structured finance, especially the stuff involving subprime mortgages (see table). As mortgage delinquencies rose, so did paper losses. Ambac and MBIA wrote assets down by a combined $8.5 billion in the past quarter.

The monolines' thin capital cushions, adequate when they wrote only safe municipal business, now look worryingly threadbare. Moody's and Standard & Poor's--the very rating agencies the monolines relied so heavily upon when piling into the mortgage business--are threatening downgrades unless they raise more equity. Ambac's failure to do so last week prompted Fitch, another rating agency, to cut its debt by two notches, to AA.

This has spooked investors for several reasons. First, heavily downgraded insurers would lose their *raison d'être* and thus face the prospect of selling up or going into "run-off": closing to new business and gradually winding down.

Worse, from a systemic point of view, when a monoline is downgraded all of the paper it has insured must be downgraded too. Hence, after its move against Ambac, Fitch went on to cut no fewer than 137,500 bonds (including one issued by Arsenal football club).

This is more than academic: holders of downgraded bonds have to mark them down under "fair value" accounting rules. Some, such as pension funds, may hold only the highest-grade securities, raising the prospect of forced sales. And, with fewer top-notch insurers to turn to, bond issuers' costs would rise. The loss of the AAA badge would cost investors and borrowers up to $200 billion, reckons Bloomberg, a financial-information firm.

Banks that were active in asset-backed markets have multiple reasons to worry. Many not only used monolines to wrap their products but also bought protection from them through credit-default swaps (CDS). One insurer, ACA, has already had problems paying out, prompting Merrill Lynch to write down its exposure to the firm by $1.9 billion. Meredith Whitney of Oppenheimer has calculated that banks may have to write off $10.1 billion of the paper they insured with ACA.

Because the CDS market is barely regulated, it is impossible to know how much of this monoline "counterparty risk" banks are exposed to. In many ways, ACA was an outlier: with a rating that never rose above single-A, it targeted inferior bond issuers (whom its boss once described as "the cream of the crap"). But downgrades could leave others struggling to pay out on policies too.

Monolines have a tiny percentage of the CDS business, according to the Bank for International Settlements. But the market is so vast that this still amounts to $95 billion of protection, most of it sold to banks. If Merrill Lynch is a guide, fully half of Wall Street's subprime and CDO hedges were booked with monolines, says Brad Hintz of Sanford Bernstein. As the risk of MBIA and Ambac defaulting has grown, he adds, so has the cost of holding once valuable hedges with them.

No wonder, then, that a group of banks is giving ear to a request from New York' s insurance regulator, Eric Dinallo, who oversees some of the big monolines, to discuss a possible rescue. In preliminary talks held on January 23rd, Mr Dinallo reportedly asked the banks to stump up as much as $15 billion to help MBIA and Ambac preserve their ratings.

The regulator, who apparently has the blessing of federal officials, is talking to other potential investors too, said to include Wilbur Ross, a vulture investor, and Warren Buffett's Berkshire Hathaway, which recently set up its own bond insurer and has not ruled out buying part of a troubled rival. These veterans believe the business has a future, despite its woes. That is because they understand that, on the municipal side at least, the market has always demanded a much higher spread than the actual cost of risk, points out CBM Group's André Cappon. Clever guarantors can exploit this gap.

It remains unclear how any bail-out would be structured. One possibility is to create the equivalent of "**bad banks**", ringfencing the monolines' tarnished CDO operations to allow their municipal businesses to continue unencumbered, or be sold. This would also assuage fears that mishaps in securitisation might bring down the public-finance markets, says Janet Tavakoli, a consultant. Another idea would be to create a so-called "excess-of-loss pool" that would allow the monolines to reinsure their nastiest tail risks.

Banks have reasons to pause before taking part. They have seen a Treasury-backed bail-out of SIVs wither for lack of interest, and they are not exactly flush with capital. But it may be a bet worth taking, however gingerly. Even if $15 billion were needed, that is thought to be a lot less than their (undisclosed) total exposure to the monolines. A painful contribution now looks preferable to another agonising round of write-downs later this year.

LOAD-DATE: February 27, 2008

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine

The Economist

January 26, 2008
U.S. Edition

It's rough out there - It's rough out there;
To come

SECTION: LEADER

LENGTH: 1037 words

Panic in the markets is scary. Among policymakers it only makes things worse

THE financial storm that blew up in America's subprime mortgage market last year has become a hurricane. The ill wind from reckless property lending blasted first the market in asset-backed securities, then banks' balance sheets and, most recently, stockmarkets. Across the globe, more than $5 trillion has disappeared from the value of public companies in the first three weeks of January. Many markets are 20% or more below their highs, the informal definition of a bear market. On January 21st share prices plunged from Brazil to Britain in the worst day of trading since September 11th 2001.

Although America's exchanges were closed that day, its policymakers' response was more than commensurate. Before Wall Street opened on January 22nd the Federal Reserve announced an unscheduled rate cut of three-quarters of a percentage point, to 3.5%, its fastest easing in a quarter of a century. A day later the New York insurance regulator and leading banks began work on a multi-billion-dollar plan to rescue the country's teetering bond insurers. As the markets pitch and yaw the pressing question is whether central bankers and regulators have acted with swift prudence, or ill-judged panic.

There is no doubt that this is a frightening moment. But the narrow economic rationale for the Fed's emergency rate-cut this week was thin. America's weak economy means monetary policy can, and should, be loosened considerably. But the central bankers' next scheduled meeting begins on January 29th. Since lower interest rates take several months to work through the economy, accelerating rate cuts by a few days will not much affect the outcome. Yes, share prices had been falling sharply across the globe, but the slide was orderly and the system had not seized up. The Fed seems to have been spooked, and wanted to stop the markets' fall ()see page 82.

That is a dangerous path for a central bank to tread. Its success will now be identified with short-term movements on Wall Street. Indeed, as the stockmarket shrugged off the latest rate cut, the Fed's authority already looked diminished. As if to prove the point, shares soared only when the insurance regulator appeared. Ben Bernanke, Fed chairman and guardian of America's economy, moved Wall Street less than Eric Dinallo, whom nobody had heard of, saying he would rescue some insurers nobody understood ()see page 81.

Rather than chasing the market's tail, the Fed ought to be asking what the markets' fall really signals. The answer is: unsurprising judgments that should not have led it to panic.

For much of last year, stockmarkets ignored the bad news from the credit markets, thanks to three assumptions. First, that policymakers, led by the Fed, would avert recession in the United States. Second, that even if America stumbled, the rest of the world economy was "decoupled" and would carry on growing healthily. And third, that the credit mess would be confined to areas related to subprime mortgages.

These assumptions were always over-optimistic. America's economy has stalled as the building bust deepens and consumers cope with the triple whammy of falling house prices, tighter credit and dearer oil. The labour market is weakening at a pace that has in the past heralded recession. The rest of the world, meanwhile, is slowing. Europe's outlook has darkened. Its banks are embroiled in the credit crisis; and one of them, Société Générale, has lost *euro*4.9 billion ($7.1 billion) in a fraud. Japan is weak; even turbo-charged China may cool.

And the credit crisis has continued to spread. Corporate lending and parts of consumer credit, such as credit cards and car loans, are wobbly. The looming downgrades--and possible bankruptcies--of the "monoline" insurers of some $2.4 trillion of bonds boded worse until Mr Dinallo moved. They would have hurt states and municipalities that are their biggest customers; and banks that had bought insurance in credit-derivative trades would also have been hit. A further round of losses at the banks could have been catastrophic. With the system at risk, no wonder stockmarkets swooned.

None of this is exactly cheerful, but it is not disastrous, either. Particular problems, like the monoline insurers, should be dealt with by particular remedies, not the warm bath of monetary policy. It is early days, but one choice for Mr Dinallo would be to corral their worst risks in a "**bad bank**", leaving the rest intact--and more tightly regulated.

As to decoupling, although the rest of the world remains somewhat vulnerable to America's troubles, most rich economies are in a slightly better shape than the United States, and most emerging ones are better able to withstand an American downturn than they were ()see page 84. Many have plenty of reserves and flexible exchange rates, making a rerun of the 1997-98 crises unlikely. Many are growing nicely on the back of rising domestic demand and regional trade links. And many have strong budget positions, leaving room for fiscal loosening to offset weakening exports.

American policymakers also have tools to cushion--if not forestall--the downturn. Lower interest rates may not stop house prices falling, nor will they prevent banks from tightening their lending standards. But monetary policy can still stimulate the economy, as lower rates boost banks' profitability, bring down firms' borrowing costs and improve indebted consumers' cash flow ()see page 86. Equally, fiscal policy will be a prop. Of course, President Bush promised too much when he suggested that a stimulus package would keep the economy "healthy". But Congress is rushing the $150 billion package through, and, even if it takes a while to reach firms and consumers, it will give the economy a boost.

Taken together, the signs from the world economy are troubling. The credit binge will not unwind quickly or gently. Asset prices will fall. But central bankers and regulators have the tools to stop a downturn from becoming a slump, so long as they use them sensibly. Reacting to market panic with panicky rate cuts is likely to make things worse rather than better. The Fed should always be the calm centre of a financial storm.

LOAD-DATE: February 27, 2008

LANGUAGE: ENGLISH

PUBLICATION-TYPE: Magazine