February 3, 2009

IMF REPORT ESTIMATES LARGE EXPECTED LOSSES IN FINANCIAL SYSTEM

"…for European and U.S. banks, (including their exposure to assets domiciled not only in the United States, but also in Europe and emerging markets), our rough estimates for expected writedowns during 2009 and 2010, partly offset by the anticipated revenues over the same period, would result in a net capital shortfall in the order of magnitude of at least half a trillion dollars."

"This implies that for U.S. and European banks taken together such an amount in new capital is necessary just to prevent their capital position from deteriorating further." –IMF Global Financial Stability Report Market Update, January 2009.

The global financial system remains under severe stress. Worsening economic conditions are producing new, large write-downs for financial institutions. In response, those institutions are paring back their balance sheets through asset sales and the retiring of maturing liabilities, including credit extensions. Those actions have increased downward pressure on asset prices and reduced credit availability. Adding to strains in the financial system are continuing job losses and reductions in overall economic activity which contribute to increases in defaults on mortgages, household loans, and business loans.

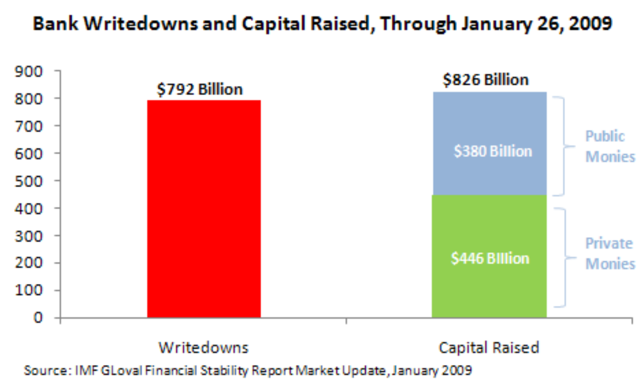
An Adverse Feedback Loop: An adverse feedback loop remains in place: loan losses and defaults add to stresses felt by financial institutions who respond by cutting back on credit availability, raising costs of what credit is extended, and selling assets in already depressed markets; diminished credit availability and higher costs of credit subsequently add to stresses of households and businesses who respond by cutting back on spending and production and by defaulting on outstanding obligations.

Since October, the adverse loop seems to have intensified. Macroeconomic risks have risen as global growth has fallen precipitously, in concert with a sharp slowdown of global trade. Credit risks have also risen as deteriorating economic and financial conditions have resulted in rising loan losses.

IMF Raised its Estimate of Financial Sector Writedowns: As an example of the rapid pace of deterioration in the financial system, the International Monetary Fund (IMF) raised its estimate of potential financial sector writedowns on U.S.-origin assets alone from $1.4 trillion in October 2008 to $2.2 trillion today. This $800 billion estimated increase in write-downs alone is more than enough to offset the entire $700 billion of financial-system relief intended by the Treasury's Troubled Asset Relief Program (TARP).

The IMF's January "Global Financial Stability Report (GFSR) Market Update" identified that much of the recent deterioration in the value of U.S. assets occurred in corporate and commercial real estate securities. Bank loan losses are also rising, "reflecting the weakening economy." Moreover, problems are spreading to other financial sectors including insurance companies, pension funds, and hedge funds. Insurance companies have significant exposure to assets whose quality is deteriorating sharply. Pension funds and hedge funds have also been hit severely on the asset side. And, in addition to U.S. assets, the deterioration is affecting assets in Europe and in emerging market countries.

New Capital Has Offset Existing Writedowns So Far… So far banks have obtained enough new capital to offset existing writedowns, mainly because of the injection of public sector funds during the final months of 2008. Even so, some banks may not have a big enough capital cushion to "weather a global economic downturn," according to the IMF.



To get an idea of the speed and size of the decline in valuations of banks, consider that the combined market capitalization of two large financial institutions, Bank of America and Citigroup Inc., totaled around $330 billion at the beginning of 2008. As of February 2 of this year, the combined market capitalization of those two institutions was roughly $50 billion.

Treasury's TARP transactions have allocated a total of $115 billion to the eight large financial institutions listed in the table below. As of February 2, the combined market capitalization of those eight institutions was around $310 billion, less than the second installment of $350 billion for the TARP. Interestingly, though not a point of advocacy, if the entire second tranche of TARP funding were used for outright purchases of large financial institutions, all eight of the institutions below could be acquired.

But IMF Estimates Warn That More Public Capital Injections May Be Needed. According to the IMF, estimates of capital needs are difficult to assess "But for European and U.S. banks, (including their exposure to assets domiciled not only in the United States, but also in Europe and emerging markets), our rough estimates indicate that at least half a trillion dollars is necessary to prevent their capital position from deteriorating further."

Large U.S. Banks, by Capitalization (billions of dollars)		
Name	Ticker Symbol	Market Capitalization February 2, 2009
JP Morgan Chase	JPM	$94.1
Wells Fargo & Co.	WFC	$63.9
Goldman Sachs Group	GS	$38.6
Bank of NY Mellon Corp.	BK	$31.2
Bank of America	BAC	$30.1
Morgan Stanley	MS	$21.8
Citigroup Inc.	C	$19.9
State Street Corp.	STT	$10.2
Total		$309.8

To date, according to the IMF, "…policy measures to cap potential bank losses and inject capital have not yet stemmed concerns about the health of the financial system ... The speed and size of the impact of the adverse feedback loop between the economy and the financial system has overwhelmed policy responses so far."

What Will Be Treasury's Next Steps? Congress and markets await details from Treasury officials and the administration regarding how they intend to use remaining TARP funds and what other plans they may have to thaw the credit freeze and restore confidence in the banking system. One option is to, in effect, nationalize major banks, which could prove enormously expensive and could undermine free-market resource allocation. Another is a so-called "bad bank" solution, in which the government purchases "bad" assets from financial institutions and corrals them into a new institution that would operate under federal control of some sort and would sell the assets off over time. This, too, could prove to be expensive and threatens to place taxpayers at risk of significant losses. We should soon hear from Treasury and the administration of further plans to confront the severe stresses that remain in financial markets.