



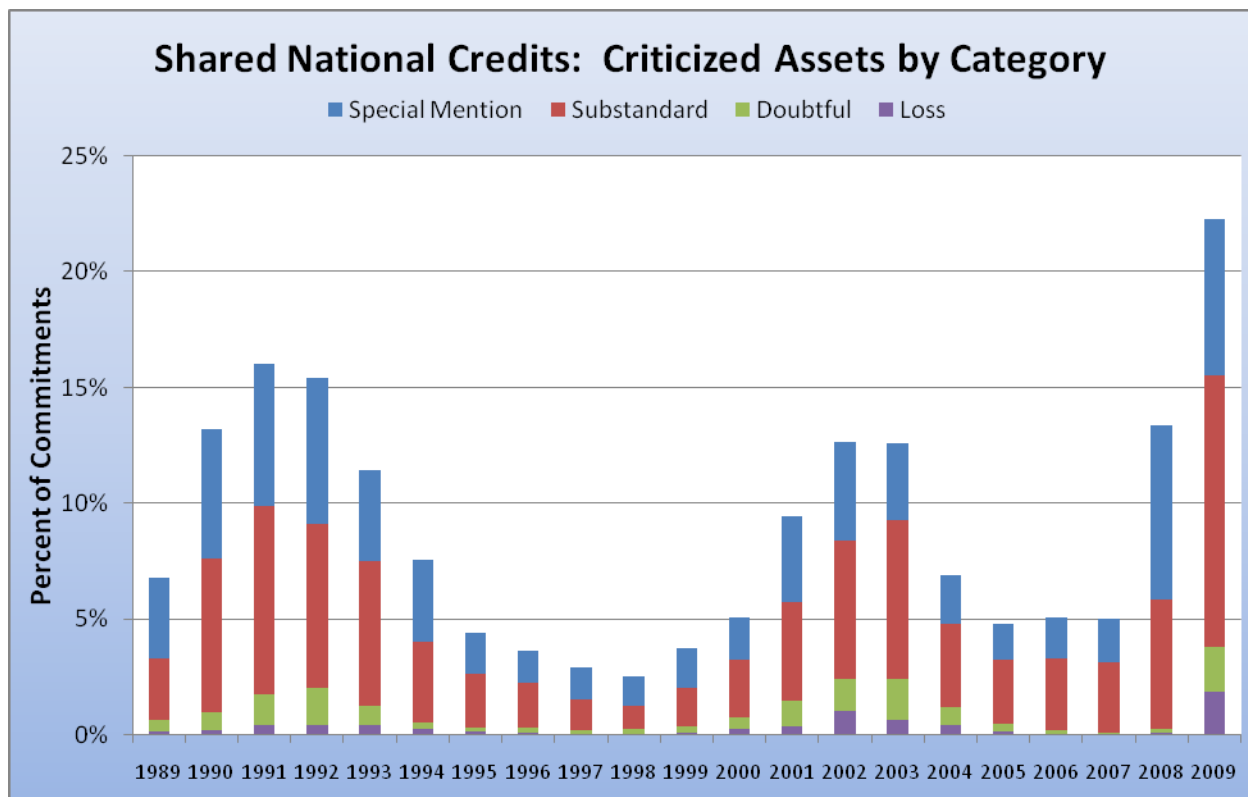
## Dysfunctional Banking System Poses Risks

September 28, 2009

“My preference would be that they [FDIC] borrow from the Treasury. As somebody noted, it’s going to look odd if they’re borrowing TARP money back from the banks.”  
– Rep. Barney Frank (D- MA)

The FDIC’s dwindling insurance fund finally has become too serious an issue to ignore. The fund has slipped to just 0.22% of insured deposits, well below the congressionally mandated minimum of 1.15%. As of June 30<sup>th</sup> the fund had just \$10.4 billion left – down 20% from the previous quarter and down 77% from \$45.2 billion a year earlier. Soaring loan defaults have claimed 95 banks so far this year.

Unfortunately, the banking system’s problems are far from over. “Credit quality declined sharply” over the past year according to an interagency report released last Thursday. The *Shared National Credits (SNC) Program 2009 Review* covers all institutional loans of at least \$20 million that are shared by three or more supervised institutions. The report identified \$642 billion in so-called “criticized” assets, which it rated in increasing order of severity as “special mention,” “substandard,” “doubtful,” and “loss.” The results are summarized in the graph below.



As the multi-colored bar for 2009 indicates, the \$642 billion in criticized assets for 2009 represent 22.3% of the SNC portfolio. The lower, purple segment of the 2009 bar represents \$53.3 billion in losses – a figure that exceeds the combined loss of the previous eight SNC reviews and nearly triples the previous high of \$19.1 billion in 2002. If there is a silver lining to be found in the report, it is that U.S. banks directly held only 30.2% of the assets rated substandard or worse. Nonbanks such as securitization pools, hedge funds, insurance companies and pension funds held 47.0%, while foreign banks held the remaining 22.8%.

The report blamed the deterioration in credit quality on “weak economic conditions affecting most industries and weak credit underwriting standards leading up to 2008.” Of course, it was those “weak credit underwriting standards” (more appropriately, “reckless lending”) that created the debt bubble whose implosion was responsible for the “weak economic conditions” in the first place. The report’s authors (FDIC, Fed, Office of the Comptroller of the Currency, and Office of Thrift Supervision) do not mention why they allowed that to happen. For example, the graph shows that even during the peak- through post-bubble years of 2005 through 2007, the agencies identified only about 5% of SNC assets as criticized. Clearly, “regulatory dysfunction” is an important component of the financial system’s problems.

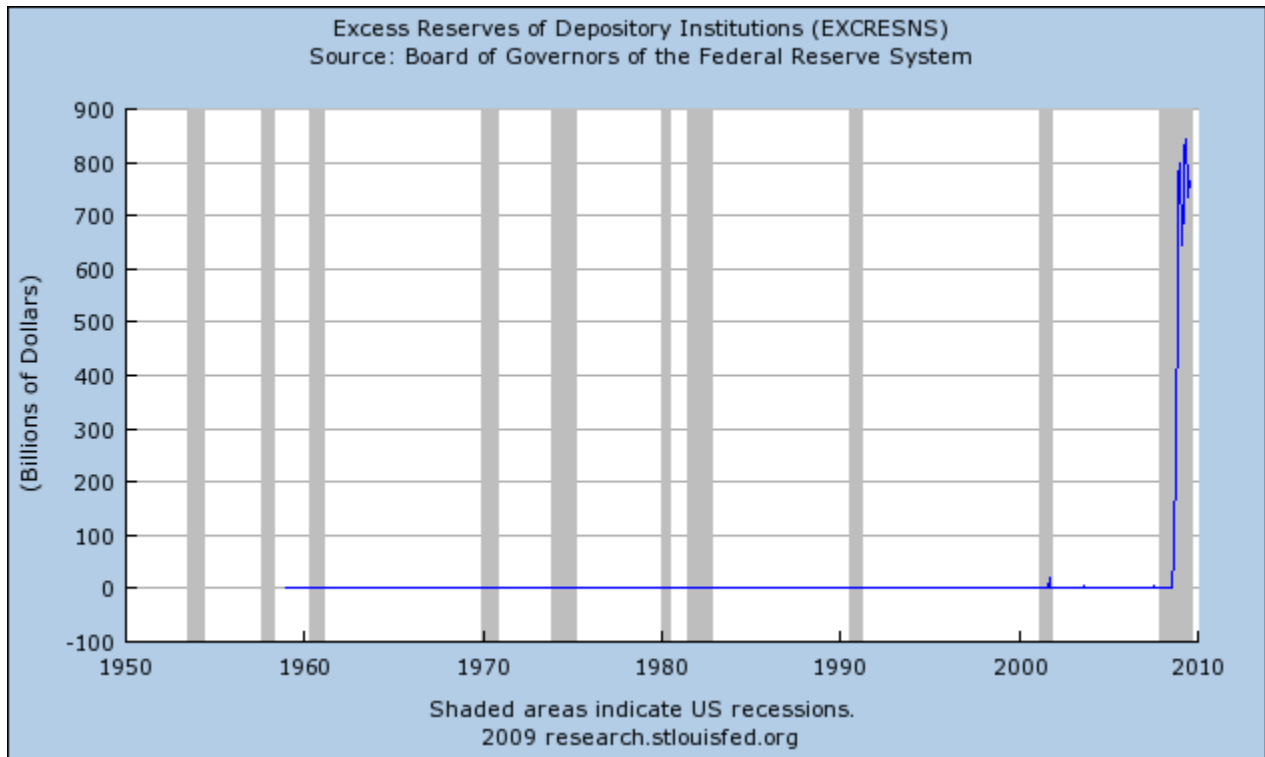
In yet another reminder that declining credit quality is an across-the-board phenomenon, Moody’s reported last Wednesday that the U.S. credit-card charge-off rate rose to a record high in August. The Moody’s charge-off index, which measures credit-card loans banks do not expect to be repaid, rose to 11.49% from 10.52% in July. Even early-stage delinquencies rose, ending a trend of four consecutive months of improvement.

## **Money and Credit Contract**

The current wave of defaults, bankruptcies and foreclosures along with rising unemployment has made banks reluctant to lend to all but the most-qualified borrowers. U.S. bank loans fell at a 14.6% annual rate to \$6.886 trillion in August from \$7.147 trillion in May. While some of the decrease was attributable to write-downs, most of it is runoff as borrowers pay back loans faster than the banks are making them. For banks receiving TARP money, the annual rate of decline was 10.1% through July as outstanding loans fell to \$4.2414 trillion from \$4.3517 trillion in April.

In a credit-based economy, credit and money are one and the same. Accordingly, the monetary aggregates have been contracting along with credit. The broadest measure of money, M3, fell at an annual rate of 2.2% when the average for June through August is compared to the previous three months. M2 and M1 both peaked during the week ended June 22<sup>nd</sup>. Since then M2 has fallen at an annual rate of 4.2% through September 14<sup>th</sup>, while the more volatile M1 measure has contracted at a 0.1% pace.

The upshot is that the Federal Reserve’s loose monetary policy is not putting money into the real economy where it is needed for economic growth. Instead, banks are hoarding cash to cover future losses on the piles of rotting assets clogging their books. The graph below nicely illustrates the massive level of excess bank reserves on deposit at the Fed. To put things into perspective, note the tiny blip in excess reserves during the last recession. That actually was a fifteen-fold spike that occurred in response to the 9/11 attacks.



## FDIC Scrambles for Cash

To make it less painful for banks to hoard cash, the Fed began paying interest on both excess reserves and required reserves last October. Now the FDIC is eyeing that stockpile as a potential way out of its own insolvency.

Among the proposals reportedly being considered as the FDIC's board meets this week, is for the agency to begin borrowing from banks. The fact that this option is even on the table reveals how deeply rooted the industry's problems have become. For one thing, it would provide banks with yet another profitable technique for sequestering money outside the private sector. Moreover, allowing the banks to effectively control the purse strings of their regulator would only tend to exacerbate that already-dysfunctional relationship.

## The Picture

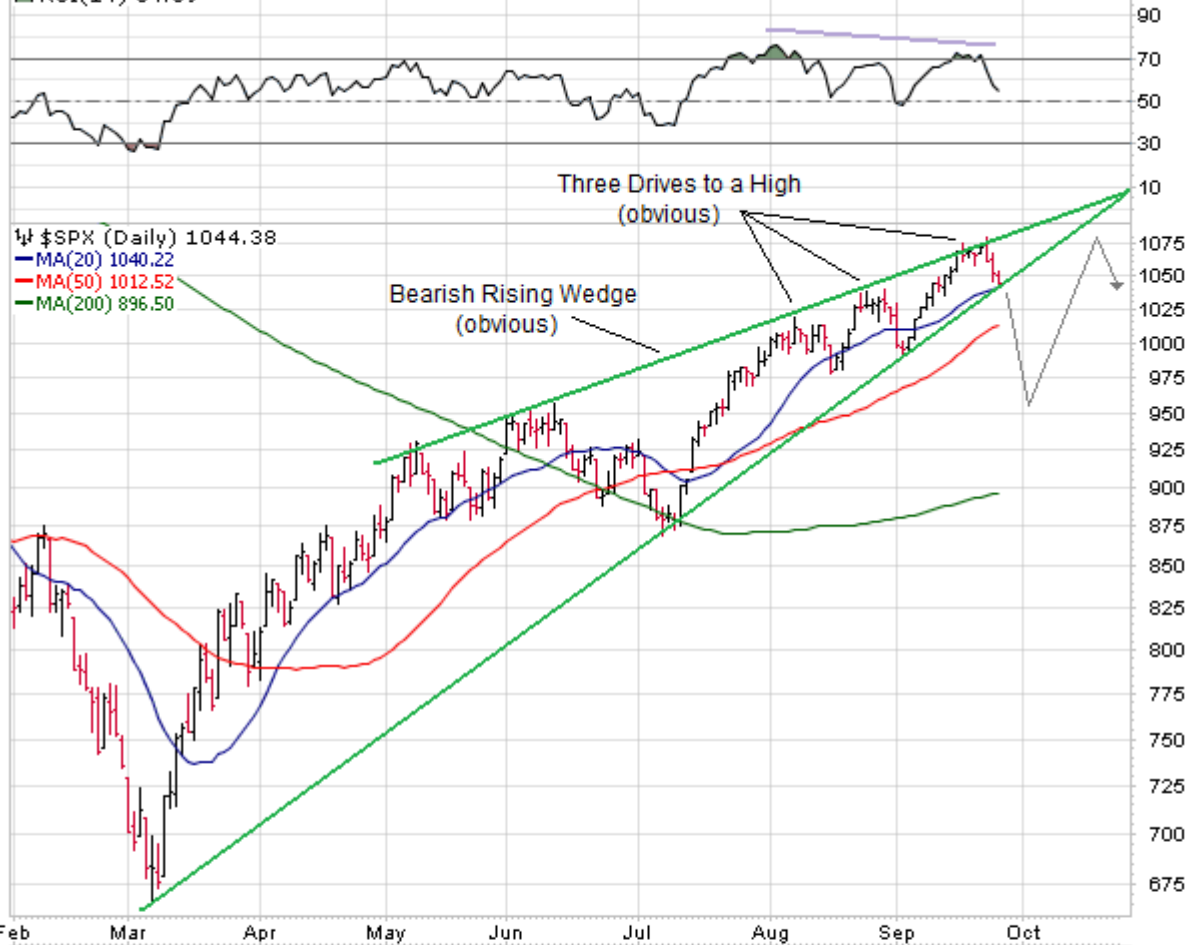
Ongoing destruction of debt on the balance sheets of banks may eventually take its toll on the stock market as well as the economy. In the meantime, the S&P 500 Index came off its high last week and found support at its 20-day simple moving average as shown in the chart below. Note that the pullback came on weakening volume and has reached the lower boundary of the bearish rising-wedge pattern that has defined the entire rally from the March lows. This now sets up an opportunity for the bulls to rally the index back to the upper boundary of the wedge and ultimately to bust the pattern to the upside. On the other hand, the failure of any such rally to materialize would set up a possible rising-wedge reversal.

**\$SPX** (S&P 500 Large Cap Index) INDX

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25-Sep-2009 **Open** 1049.48 **High** 1053.47 **Low** 1041.17 **Close** 1044.38 **Volume** 3.8B **Chg** -6.40 (-0.61%) ▼

▲ RSI(14) 54.39



■ Volume 3,762,382,848

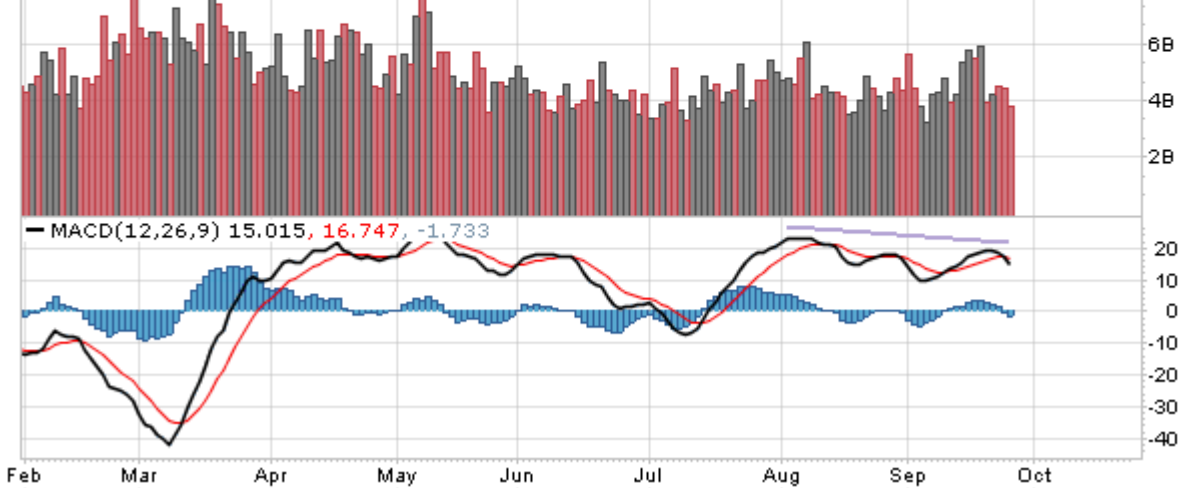


Chart courtesy of [StockCharts.com](http://StockCharts.com)

Rising-wedge patterns are characteristic of exhaustion-style trends. As corrections become shallower and shallower, the loss of upside momentum on each successive high gives the pattern its bearish bias. Declining momentum – as measured by RSI and MACD – is indicated in purple on the chart. In the case of MACD, momentum actually peaked when the stress-test results were released in early May.

Another characteristic of the current circumstance is the three-thrust distribution pattern noted on the chart and sometimes referred to as “three drives to a high.” The presence of this component within the rising wedge increases the probability of a bearish resolution.

The gray arrow on the chart indicates one probable scenario for a rising-wedge reversal. While the breakdown is shown as taking place immediately, it could happen at any time during the next month or so as long as the rising-wedge pattern remains intact. Under any such scenario it will be important to examine the rally off the initial low for countertrend characteristics. That should help to determine whether the reversal is just a temporary correction, or whether the underlying trend has changed from up to down.

Short-term support is at 1,042 and at 1,039. On a breakdown from the rising wedge, support should come in at 1,013-1,018 and at 992 and 978. Key support is at 955. Resistance is at 1,053 and at 1,080.

Though it is tempting to think we have been clever in uncovering the bearish rising wedge and the three-thrust pattern, in truth they have become very obvious. In general, information that is widely known tends to be of little or no value. With that having been said, sometimes the obvious does occur. Either way, the next several weeks should prove interesting.

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