

# It Was the Best of Times, It Was the Worst of Times...The “Minsky Moment” Has Arrived

The news is startling: Bear Stearns, IndyMac, Merrill Lynch, Lehman, WAMU, Wachovia, AIG, Fannie & Freddie – each massive failure, merger and bailout has had a profound effect on the financial landscape, not just in the U.S., but worldwide. The credit crisis contagion has plagued every market and resulted in a worldwide financial meltdown with no end in sight.

Who would have thought many of our country’s long-held bastions of free enterprise, household names, and familiar brands would have gone the way of the dinosaur or be teetering on the precipice of bankruptcy? That national and world credit and stock markets would be in such turmoil, despite central bank rate cuts (expect more to come) and hundreds of billions of federal dollars committed to bailout plans? Or that Treasury rates would yield as low as 1 basis point on the short end and barely above 3 percent for 10-year treasuries? All this and more has happened in little more than the proverbial blink of an eye.

Against this background, I think about the financial situations of many of the banks in this country. While some celebrate the steepening of the yield curve and the widening of credit spreads that provides relief to margin compression, others are not so fortunate and are experiencing pain from credit losses and the accompanying domino affect these losses have on access to liquidity, capital and, ultimately, the ability to survive.

## Financial Crisis Vindicates the Economics of Hyman Minsky

Hyman Minsky (1919-1996) was considered a radical member of the Keynesian school of economics who spent his career studying economic booms and busts. His theory was that “stability breeds instability” and the longer the period of stability, the greater the period of instability when the moment of instability occurs. During “good” times, businesses in profitable sectors of the economy are handsomely rewarded for increasing their levels of debt. The more money they borrow, the more profits they seem to make. This rising profit attracts other entrepreneurs/businesses to jump on the band wagon and raise their level of debt. Since the economy is healthy and borrowers’ financial health shows continued improvement, this makes lenders more eager to lend (sound familiar yet?). As time passes, the pace of debt accumulation rises much faster

than the borrowers’ ability to repay and service the debt. At this point, the foundation for an economic bust is set in motion. Seem like a reasonable theory?

## How Did We Get Here

To begin with, we experienced a long period of credit stability, global growth and wealth creation that persisted from the early 1990’s. Money was easy (too easy) to get, and capital was as simple as ordering from Dominos, except it took 20 days, not 20 minutes – sometimes faster. The real estate gold rush along with a raging bull market in nearly every stock market in the universe made individuals feel wealthy, overly optimistic and confident. This confidence led to increased risk taking and speculation, combined with massive leverage, creating one of history’s biggest bubbles. Add on top of all this FASB/SEC fair value accounting (FAS157) and you have a perfect formula for a “Minsky Moment.”

However, in every crisis there are silver linings as well as phenomenal opportunities if one looks hard enough and has the courage to capitalize on them. Neither is easy. Both are key!



## Déjà vu All Over Again

Not quite! While the drop in the Fed funds rate to 1 percent and the steepening of the curve is reminiscent of recent times (2001-02), this recession is unlike any we’ve experienced in nearly 100 years. Major contributors to past recessions were currency crises, inflation, national debt, protectionism. Not this time! This recession was caused by none of these; rather, this recession was caused primarily by bad lending practices, loose money and overly harsh mark-to-market accounting rules. Therefore, this time around may be different, particularly if Minsky’s theory proves right.

## What’s a Banker to Do

The current environment provides some phenomenal opportunities for banks, particularly for those with strong capital. Outlined below are just a few simple strategies most banks can put into place immediately with very low risk at this point “in the cycle.” Most of these ideas are not new - all are

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timely. The key is execution and understanding of the impact to your bank's risk profile, including interest rate risk, liquidity and capital.

## Roll Short or Time to Extend Funding? Cost of Funds Management Thoughts

First things first; here's the simplest, yet hardest, choice most banks face today when it comes to cost of funds management: lowering your deposit rates! To the degree possible, this is instant margin relief. The single biggest contributor to margin compression for most banks is the high cost of deposits currently.

With asset yields remaining 'sticky' (refinancing activity is almost non-existent) and overnight borrowing rates below 50 basis points,

spreads should be widening for many banks. Unfortunately, irrational deposit pricing by competitors prevents many banks from taking a more aggressive deposit pricing posture. Many fear loss of deposits that they cannot afford to give up, while others fear loss of relationships. We've written enough articles on this subject that I am going to cut to the chase on this one. If you want to continue paying up for time deposits, how can you make up the difference in added expense? Perhaps squeezing as much as possible out of non-maturity deposits is a logical consideration. Non-maturity deposits are less rate-sensitive and, given the current financial crisis, rate is secondary to safety and convenience. Secondly, you could

consider leverage to offset the cost (more on this later).

Short-term borrowings are available at 35 basis points! Yes, you can borrow overnight at most FHLB's at a quarter to half point. Many bankers are unaware of this opportunity – most should take advantage now! Consider the marginal cost of keeping your CD rates high when the outflow can be replaced at the margin for one third of one percent (or at Fed Funds + 25bps using the Fed BIC, per George Darling's Bulletin last month)!

The steep curve, abnormally wide credit spreads, and associated liquidity premium accorded to all agency debt have

combined to make long-term FHLB advances "unattractive" relative to overnight advances. Beyond one month, advances have become progressively more

**"Things work out best for those who make the best of the way things work out."**

~ John Wooden

expensive (currently).

For now, rolling funding short may just be best for most banks. Until longer-term borrowing rates become more attractive (forget long-term CD's), long-term swap rates are very attractive versus FHLB. However, two issues generally cause banks to reconsider the use of swaps; namely, FAS133 and, more recently, counterparty risk!

## A Lenders' Market

Banks should revisit their loan pricing methodology to ensure that loans are being priced to reflect the same risk premiums paid in the capital markets. Our September Bulletin outlined in detail how banks should consider pricing loans and how to compete with greater leverage in loan negotiations. Given that 30-year GNMA's are yielding at or above 6 percent, with zero credit risk and zero RBC requirements, it would seem ludicrous to price fixed-rate commercial loans within even 100 bps of a 6 percent effective yield, particularly given that GNMA's are also extremely liquid. Also, consider "floors in the money" for floating-rate loans at these rate levels. For instance, a Prime plus 1.50 percent loan should be priced at no less than a 6 percent starting rate today (i.e. 50 bps in the money).

Banks should also revisit their fixed-rate loan pricing indexes to ensure rational pricing. For instance, loans priced at 300 basis points over the five-year FHLB advance rate might be too rich and non-competitive today due to widening spreads mentioned above, while those same loans might be priced too lean based on the same spread to the swap curve today. You might consider pricing loans at a lower spread to FHLB today, but write in the 300 basis point spread to FHLB upon repricing.



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## Leverage Opportunities/Pre-investment Strategies


Agency investment yields are very attractive today relatively speaking. Spreads have reached historic levels and, as such, should not be ignored. Banks with excess capital have a phenomenal opportunity to grab 6 percent yields on GNMA's, 3 percent on very short-term agencies and 5 percent yields on agency ARM's. Even "certain" callable bonds are worth considering now!

I cannot recall a time when the opportunity costs of sitting on excess cash has been so expensive. For many of our clients we have already pre-invested the next six to nine months of investment cash flow. This strategy serves multiple purposes including taking advantage of borrowing rates below 50 basis points while locking in very attractive yields on investments. For asset sensitive banks, the greater risk in not taking this action is that these yields might not be around six months from now. Secondly, the strategy helps protect banks against a sustained low rate environment and even a rising rate environment because of the huge cushion the steep yield curve provides. Lastly, for many banks the outlook for loans is lackluster and earnings pressures are rising. The leverage ensures that these banks maintain a certain asset size to cover increasing operating expenses and to remain profitable. Shrinkage for most banks is not desirable in this rate environment. Regardless of a bank's interest rate risk profile, there are terrific leverage opportunities available today, some not seen in a lifetime. Obviously it is wise to assess your bank's investment strategy to ensure it is aligned with your overall balance sheet risk management objectives.

## Conclusion

The Minsky Moment won't last forever. This cycle will end and the industry will survive, albeit most likely in a different form. In the meantime, we should not lose sight of the opportunities that surround us. Banks must take on some degree of risk to make money and survive. Risks should be measured and monitored with long-term implications considered. There is no "one size fits all" strategy that we can recommend to all banks. However, the few simple strategies outlined in this article will hopefully help give an immediate boost and a head start as we

head into 2009. While many bankers are exceedingly overwhelmed by the current economic maelstrom pulling them toward what they think is the abyss, in the process they are missing phenomenal opportunities. For some it is the best of times, for others it is the worst. John Wooden put times like this in perspective when he said, "Things work our best for those who make the best of the way things work out."

*About the Author: Frank L. Farone is the Managing Director of the Darling Consulting Group in Newburyport, MA. He is also a presenter for the PBA Senior Management Financial Education Series.* 



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