

# **Crunch Time**

## **An Economic and Market Update**

**Chicago Association for Business Economics, May 2008**

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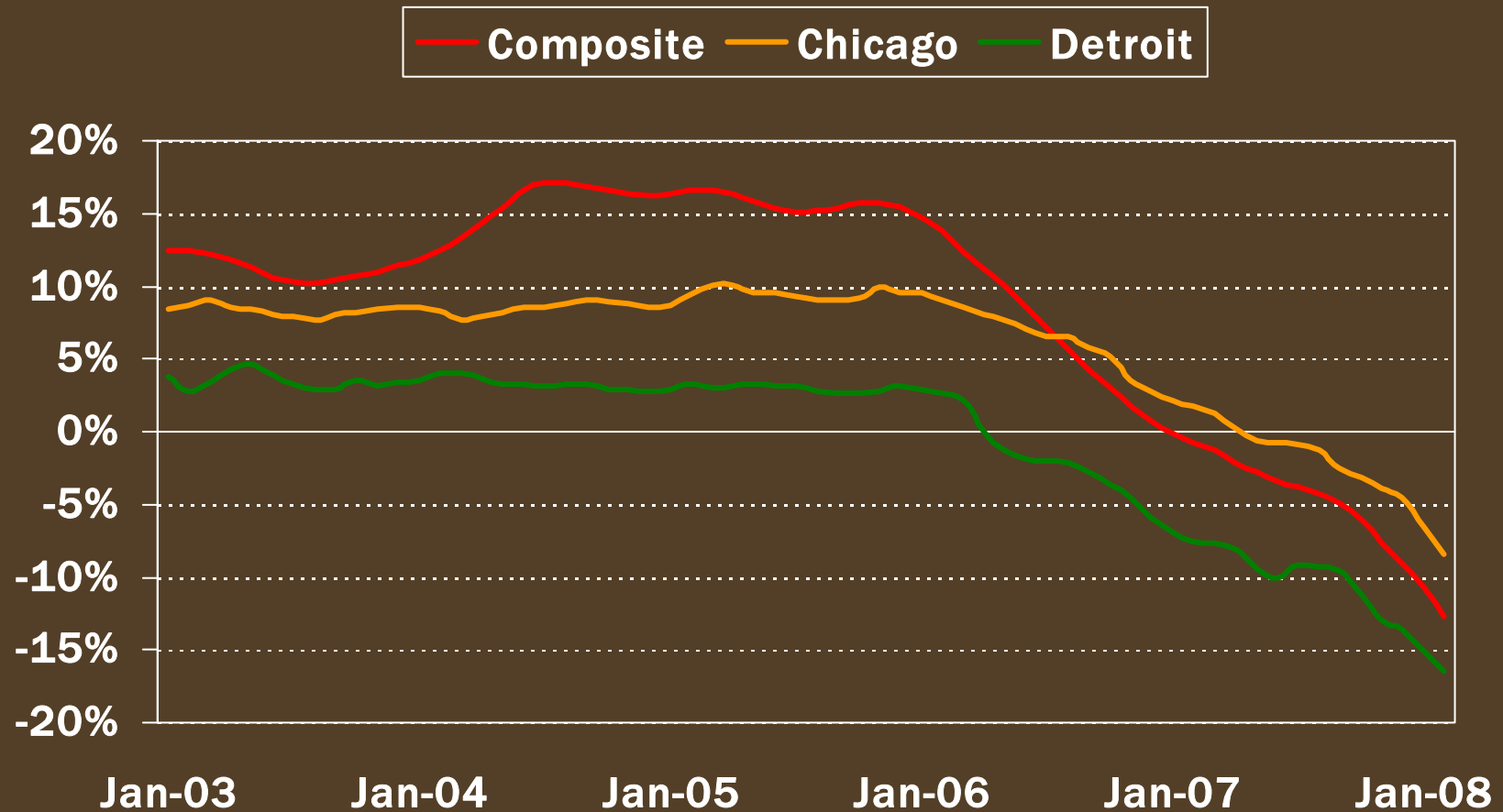
# Outline

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- **Underlying Trends: The “Real Economy”**
- **The State of the Financial Sector**
- **Will There Be a Feedback Loop to the “Real Economy?”**
- **Lessons Learned**

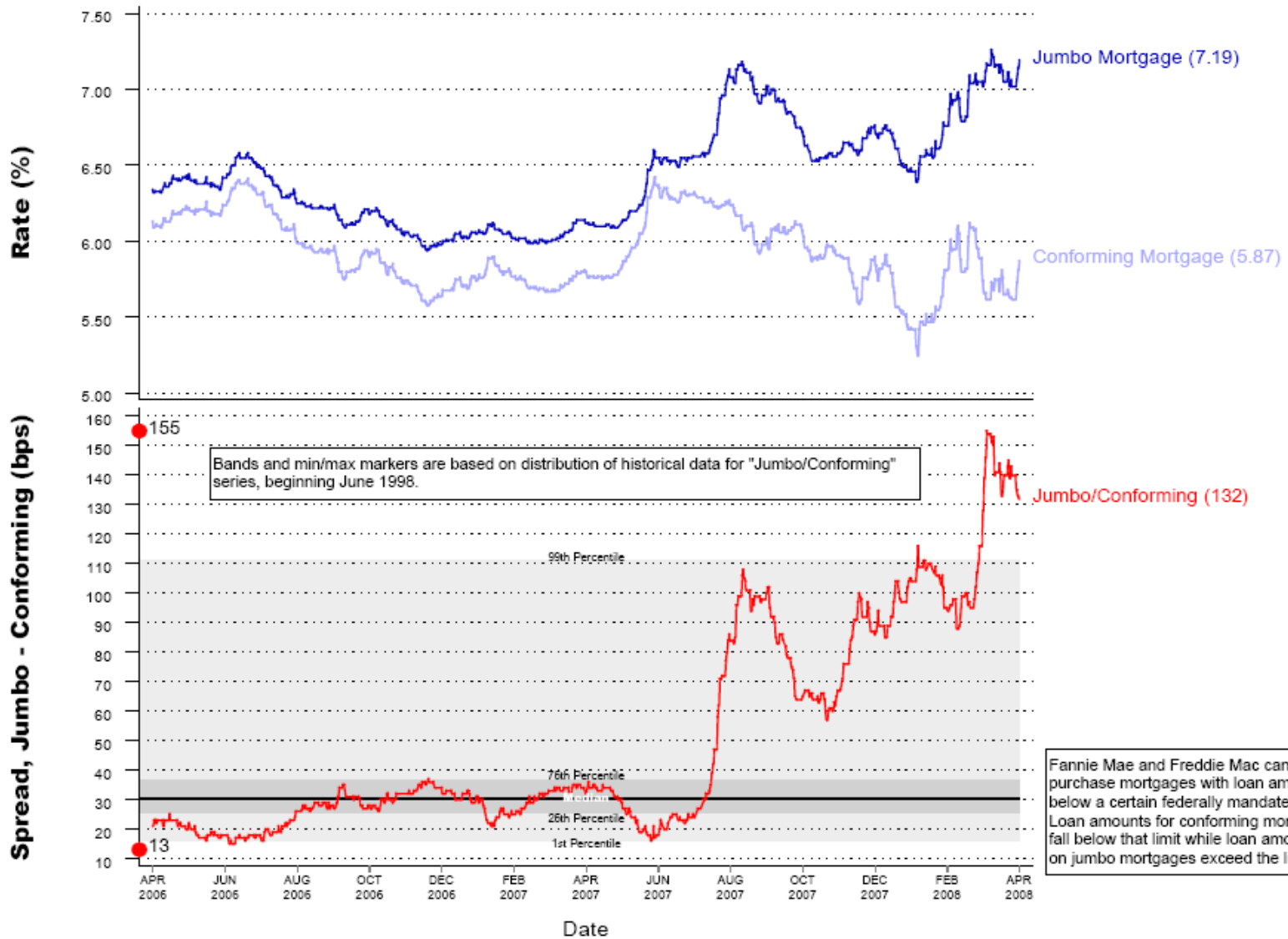
# Home Prices

## Year over Year Change, Case-Shiller Index



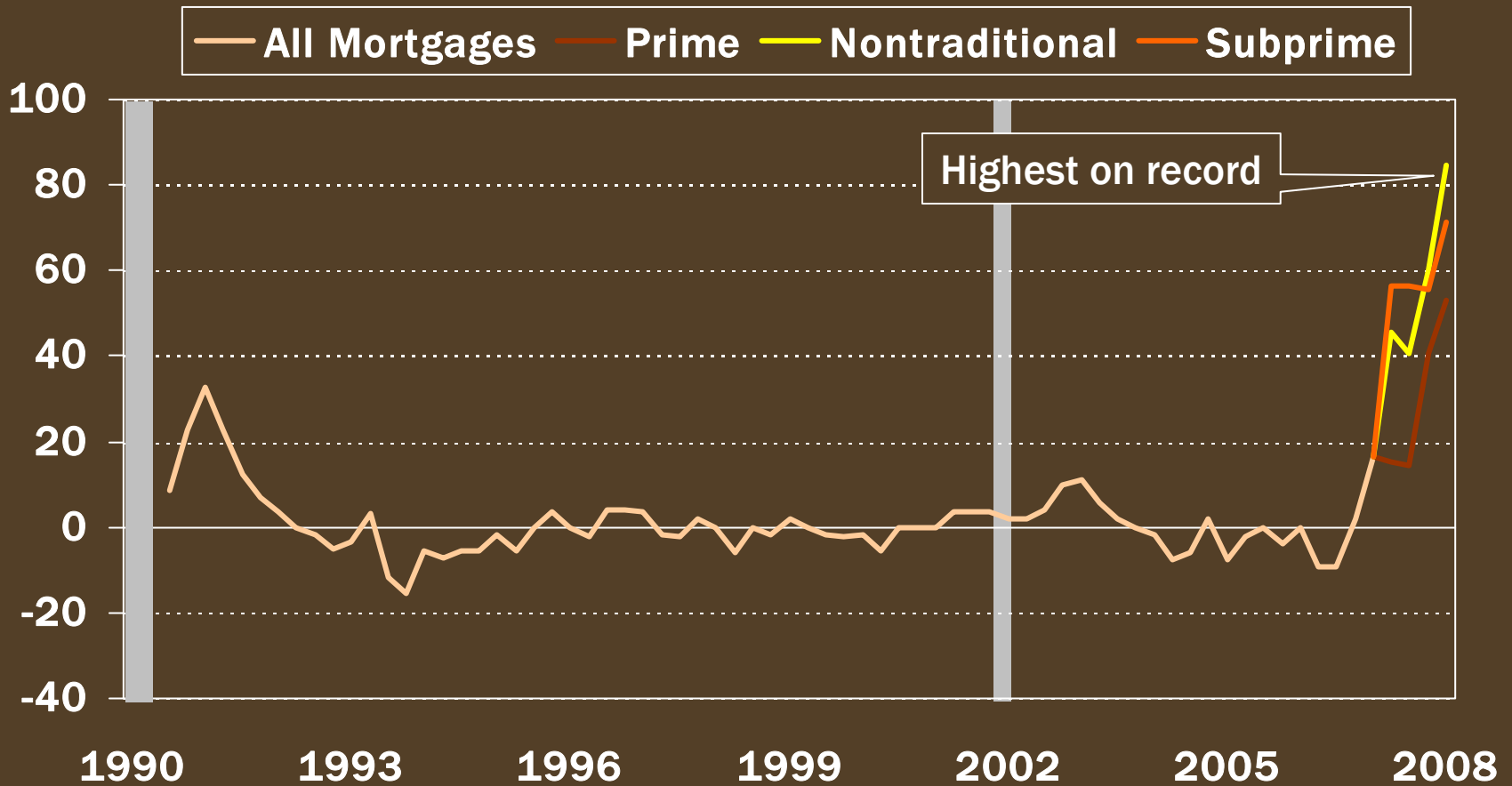
# Spread between Jumbo and Conforming 30yr. Fixed Mortgage Rates<sup>4</sup>

Weekdays, April 17, 2006 to April 17, 2008, (Value for most recent date in parentheses)



# Senior Loan Officer Survey: Home Mortgages

## Net Percentage of Respondents Tightening Credit



Source: Federal Reserve

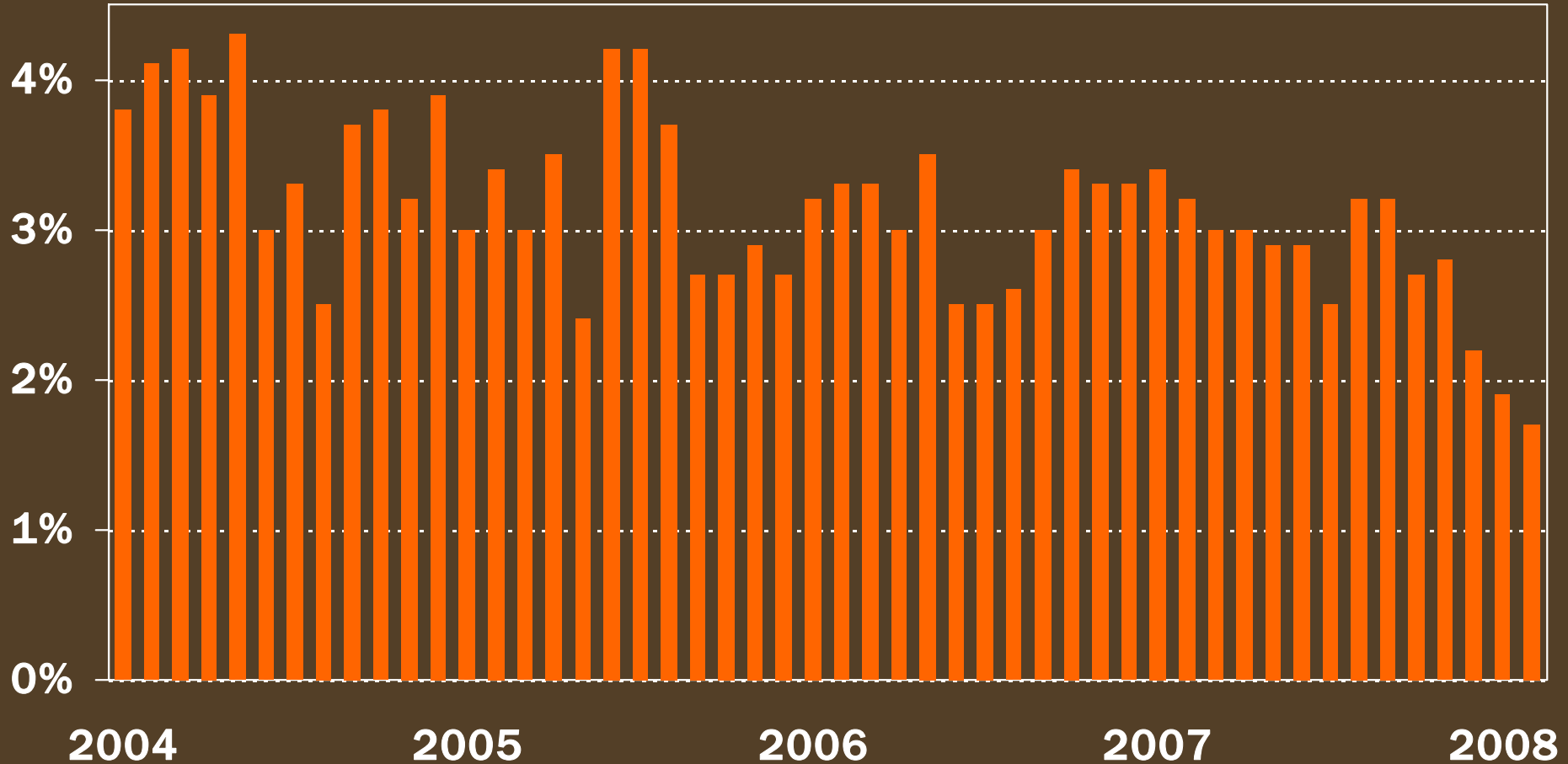
# Fallout from Housing

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- **Significant drop in construction**
  - Affects building materials, trades
- **Broad pressure on home values**
  - Negative “wealth effect”
- **Shivers roll through financial markets**
  - Potential for a credit crunch
- **Risk of ill-advised regulation**
  - A potent political issue

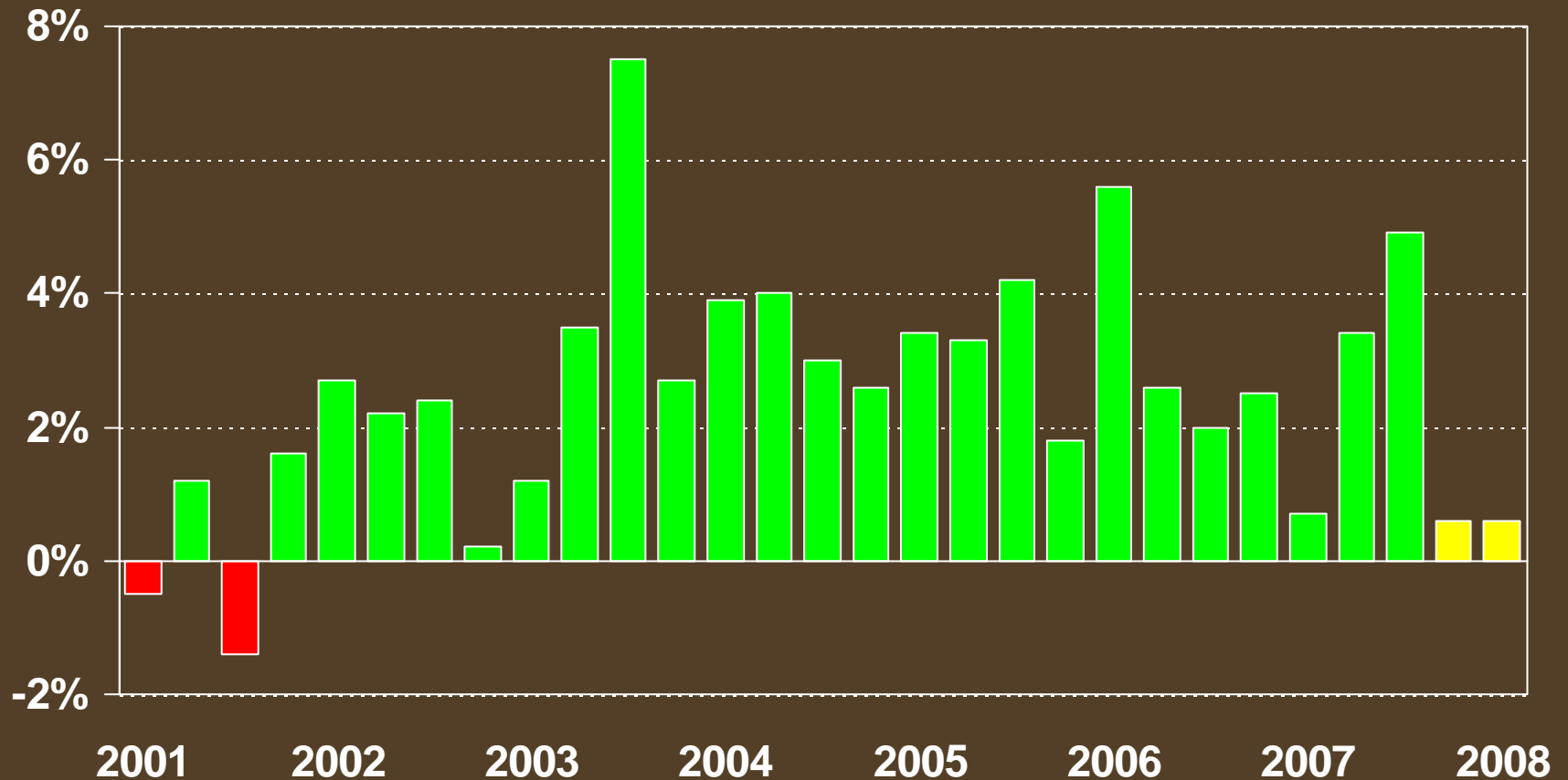
# Real Personal Consumption

Year over Year Change

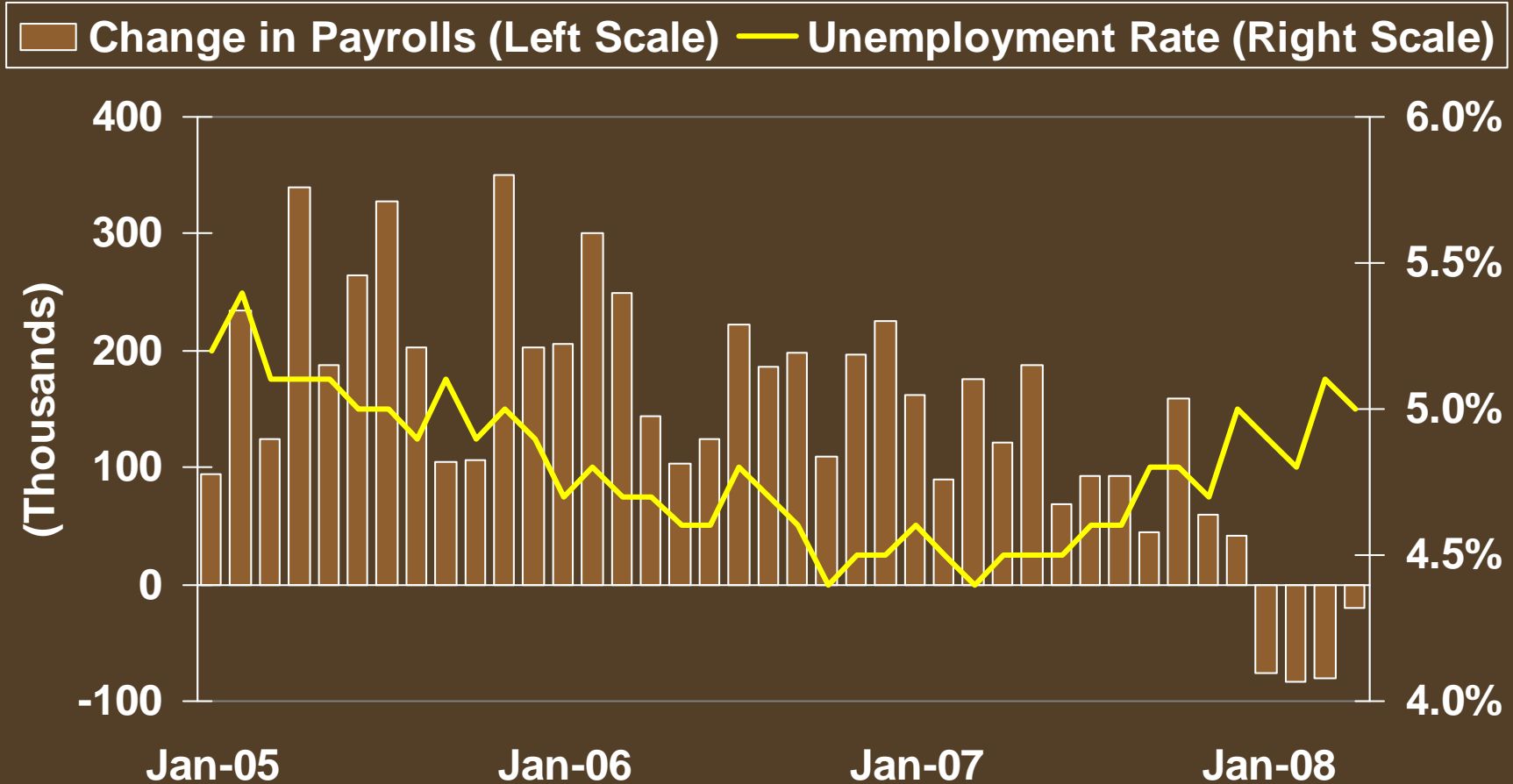


# Is the Expansion Over?

Quarterly Change in US GDP, Annualized



# Employment Trends



Source: Bureau of Labor Statistics

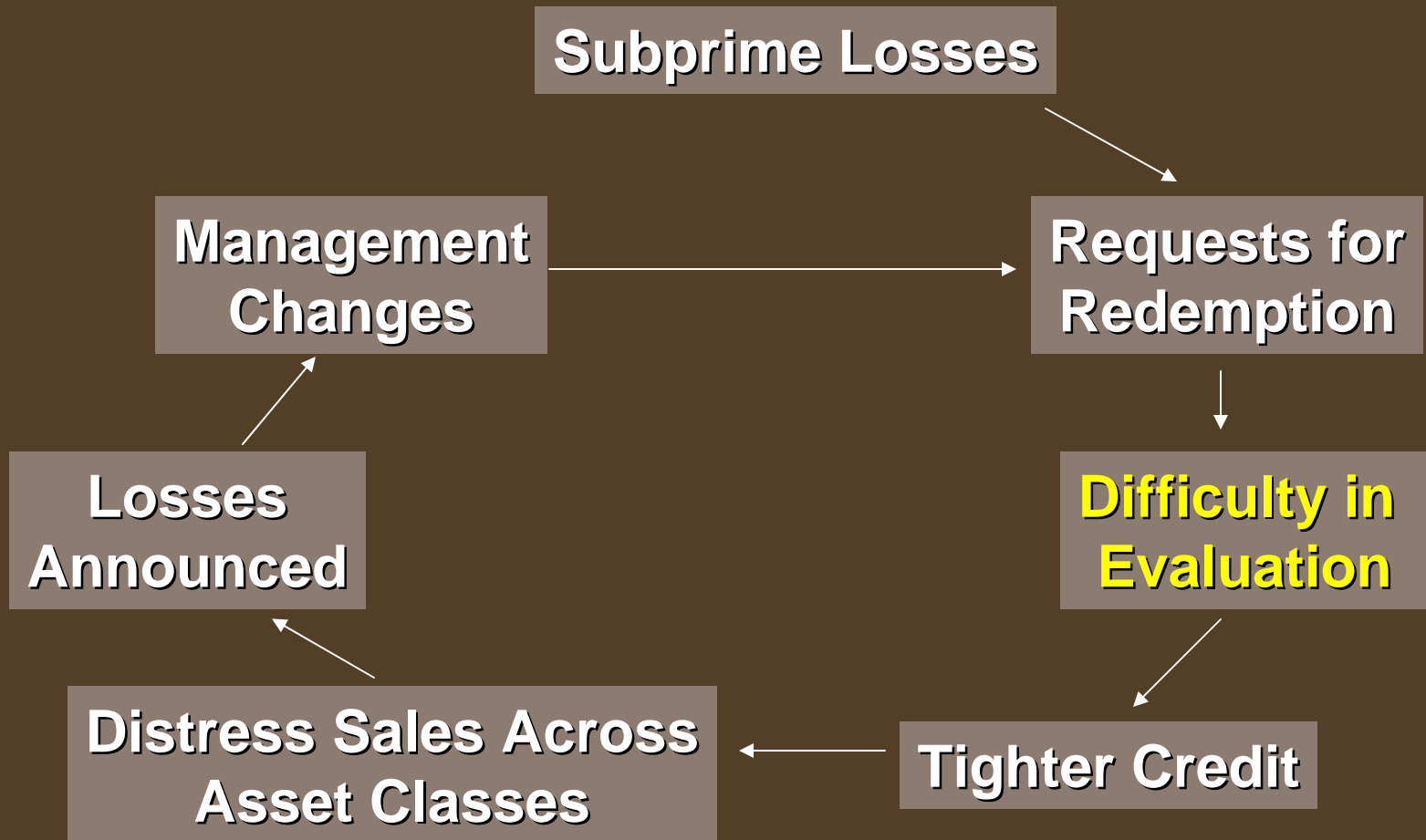
# Outline

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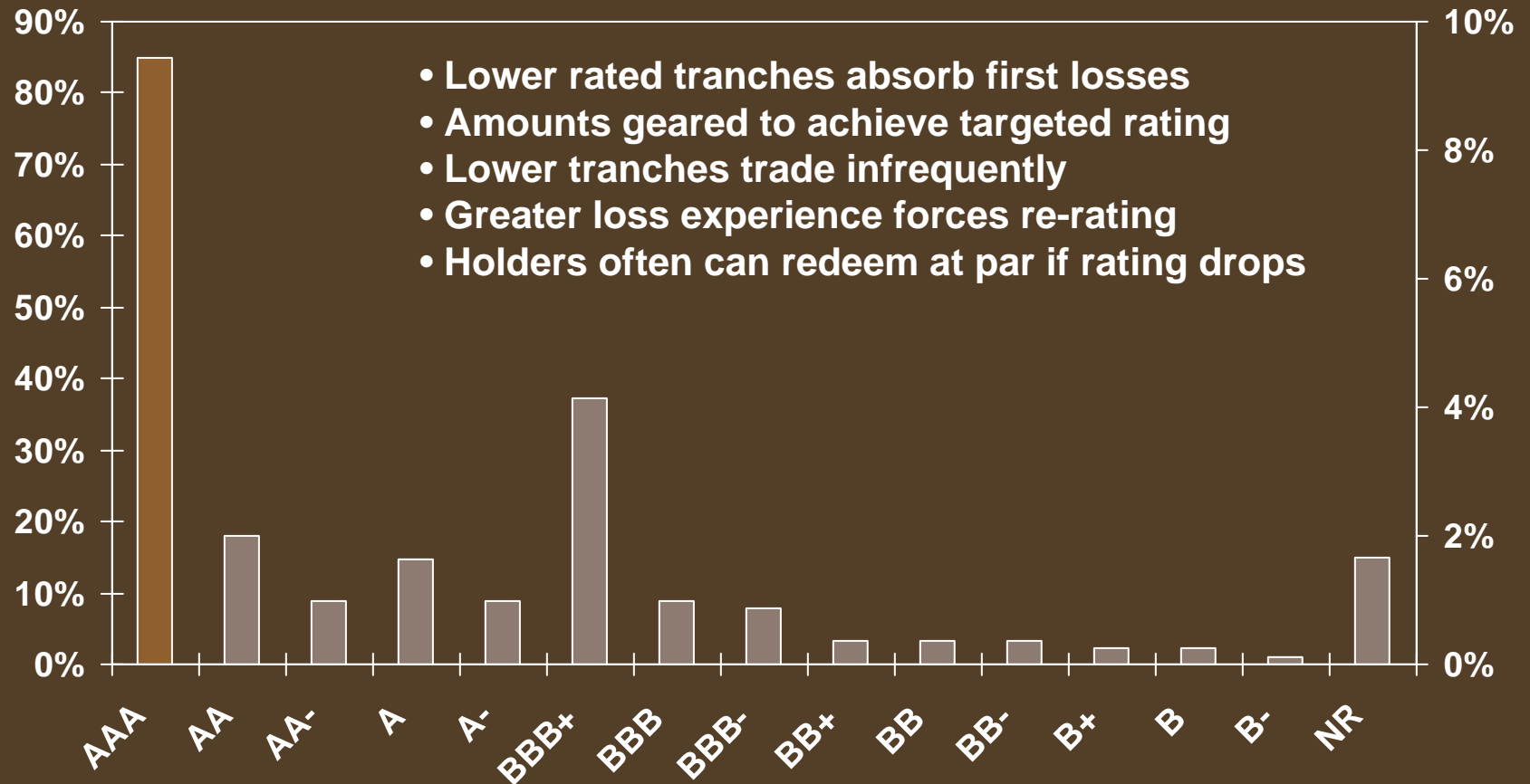
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# Spiraling Downward

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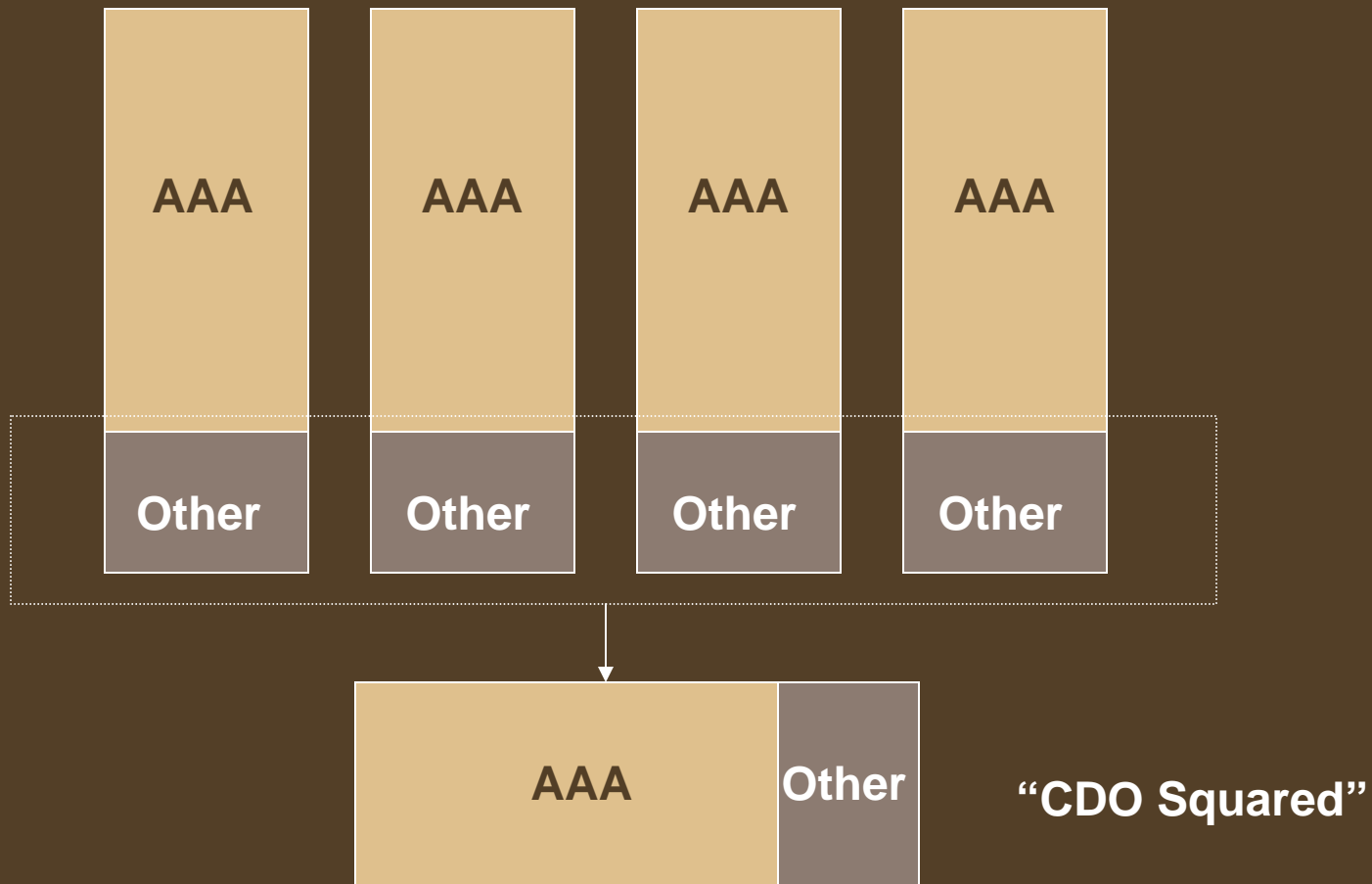


# Inside a CDO



# Doubling Down

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# “Marking to Muddle”

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- Structuring has met very specific risk/reward demands, but has created a very heterogeneous market
- Many sectors don't trade fluidly or frequently
- Few analogs available
- Information infrastructure has fallen behind
- Modeled results increasingly invalid
- Is impairment temporary?
- **The problem: what's the alternative? Current discussions over the ALLL will be just as hard**

# Did Market Value Accounting Help or Hurt?

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## Helped

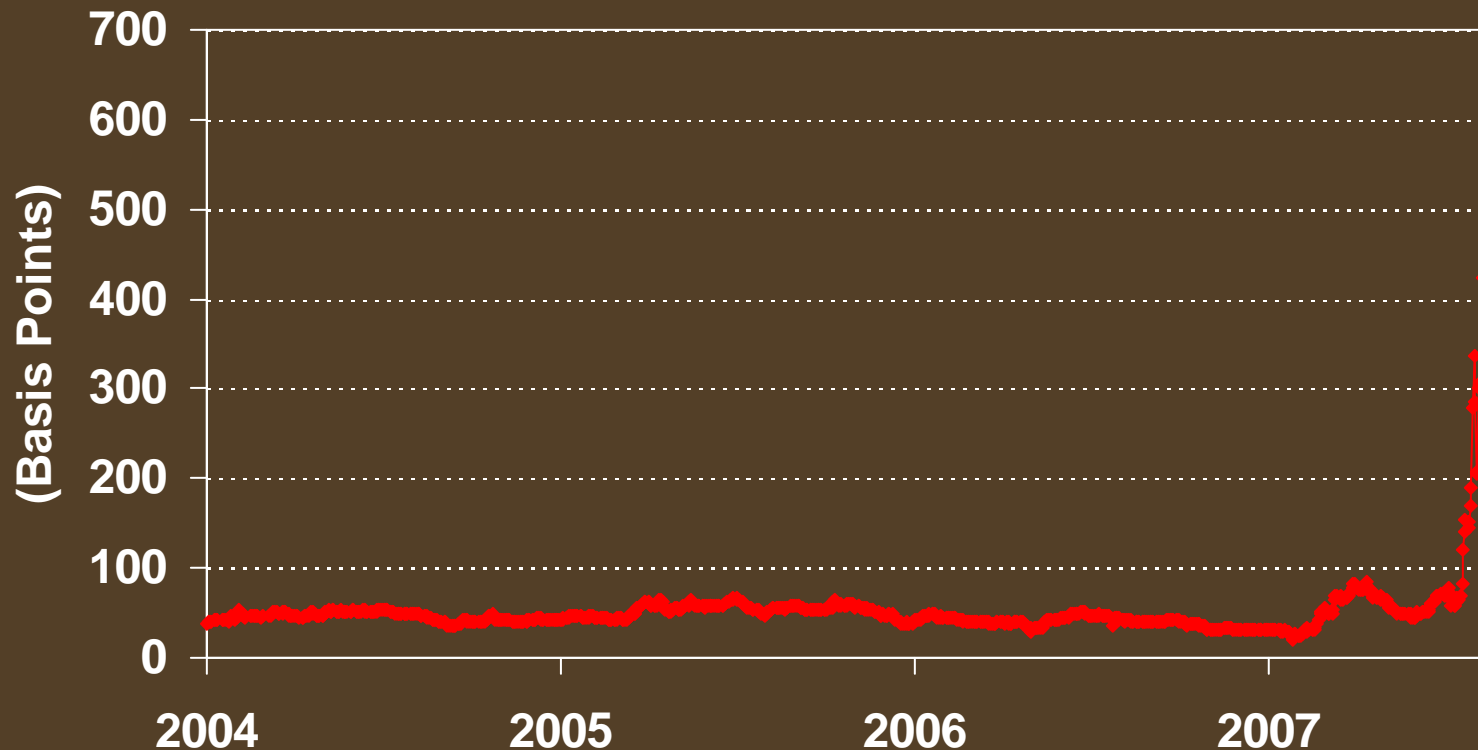
- Takes a long view
- Is unaffected by the vagaries of accrual accounting
- Puts embedded options into clear relief
- Better reflects actively managed positions
- An early warning system

## Hurt

- Suffers from the vagaries of market pricing
- Ties with earnings are often hard to define
- Rules mark assets but not liabilities (the perversion of distressed debt)
- Does not distinguish between expected losses and illiquidity

# VaR and the Market Cycle

## Countrywide Credit Default Swap



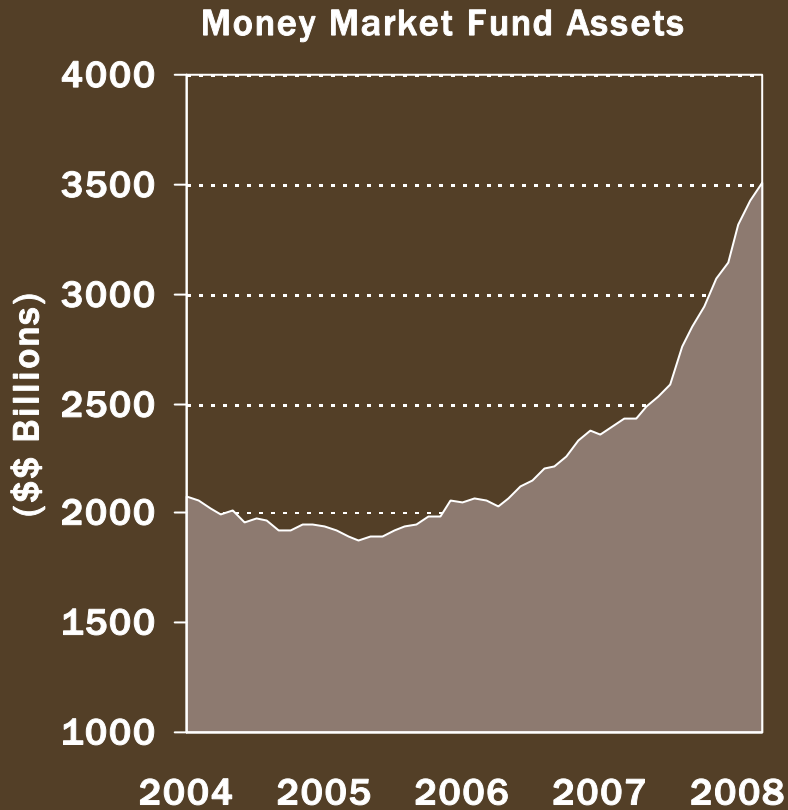
- Increasing absorption of risk limits crowds out new financing
- Banks pull back at exactly the time credit may be most needed!

# Other Accelerants

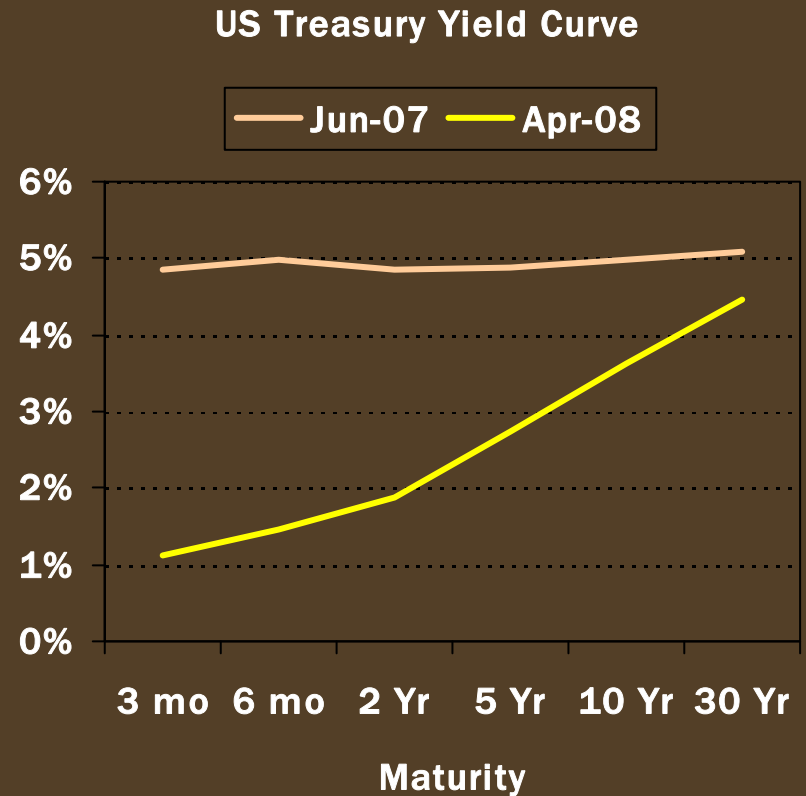
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- **Computer-guided stop-loss provisions**
- **Compensation schemes promote profit taking while the profits are still there**
- **Institutional inexperience**
- **Short time horizons**
- **Speed of trading and money movement**
- **Shrinking risk appetites**
- **Breakdown of correlations and portfolio effects**
- **Modern risk management techniques are coming under great fire**

# Signs of Investor Conservatism



Source: ICI



Source: Bloomberg

• *This money will eventually have to go back to work!*

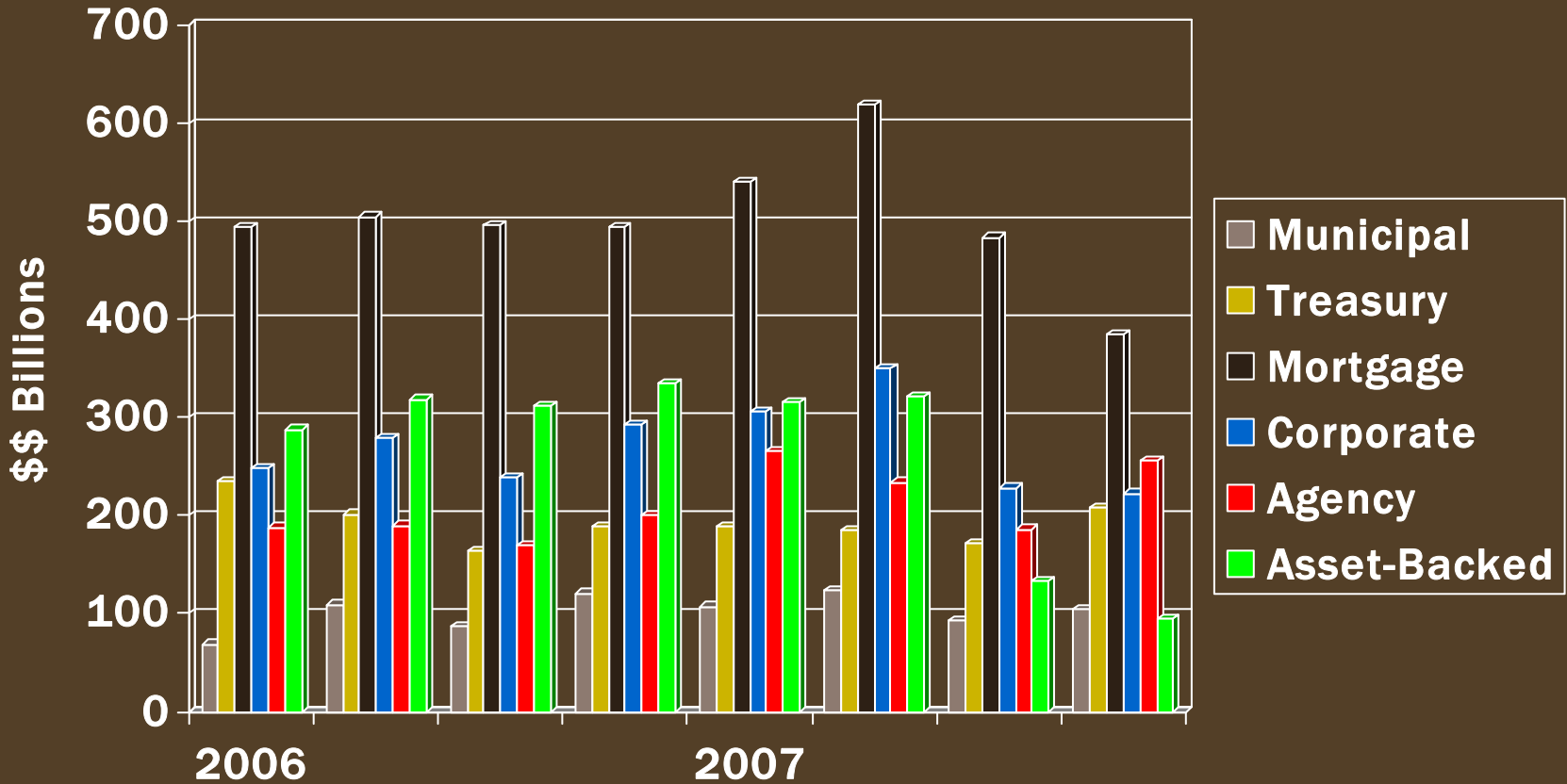
# Credit Conditions: May 2008

## Summary Comments

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- Short-term financing pressures persist
- Market credit stress remains significant; worse, in spots, than last fall
- Bank balance sheets have swollen with assets that would normally be securitized
- Banks are moving to ration available capital and liquidity by tightening credit standards
- Signs point to extreme concern over counterparty exposure
- Rating agencies and credit committees are rapidly reassessing
- Modern corporate finance is, perhaps, even more pro-cyclical than the system it replaced
- There is every chance that the growing credit crunch will make recovery more difficult

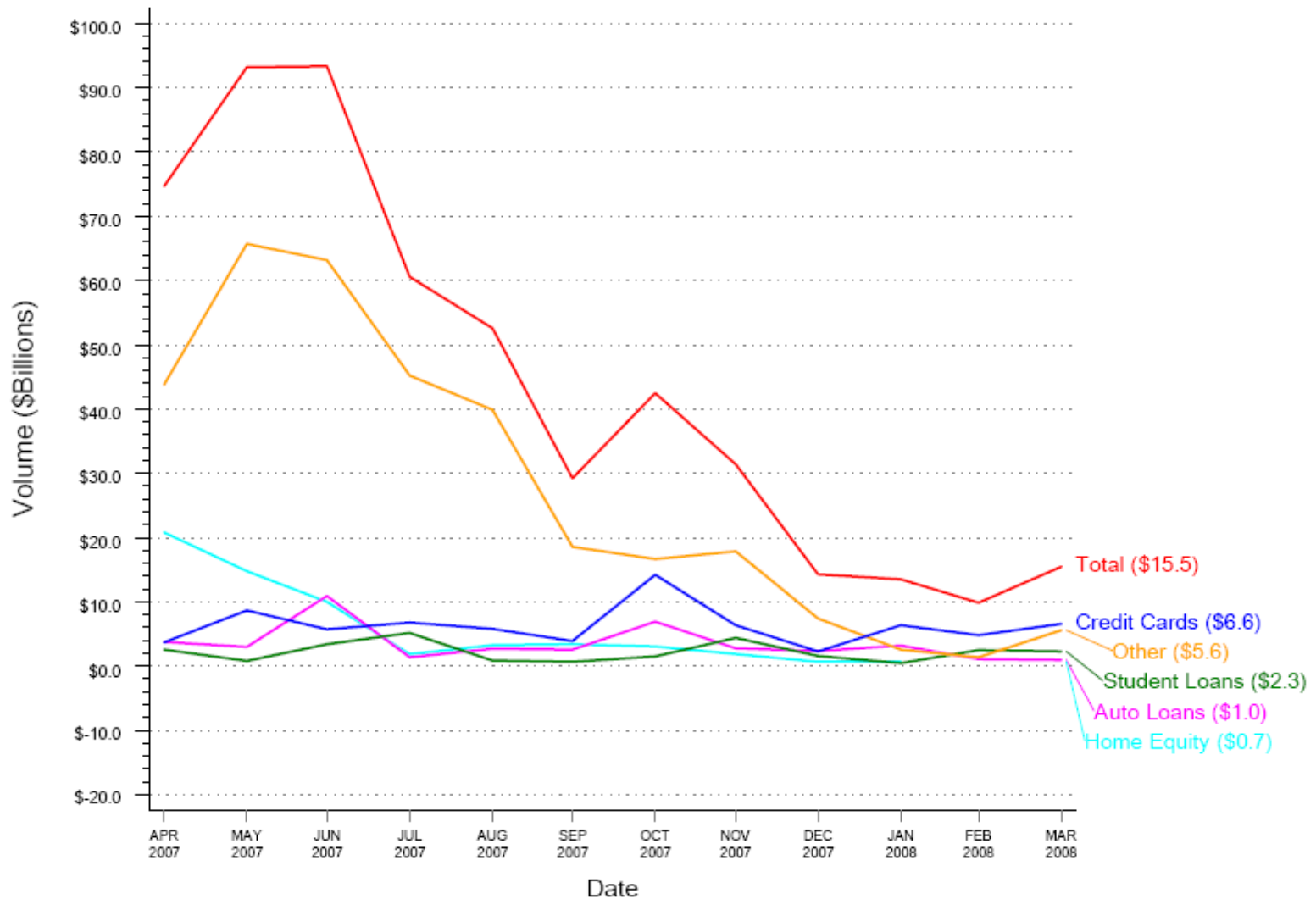
# New Debt Issues



Source: SIFMA

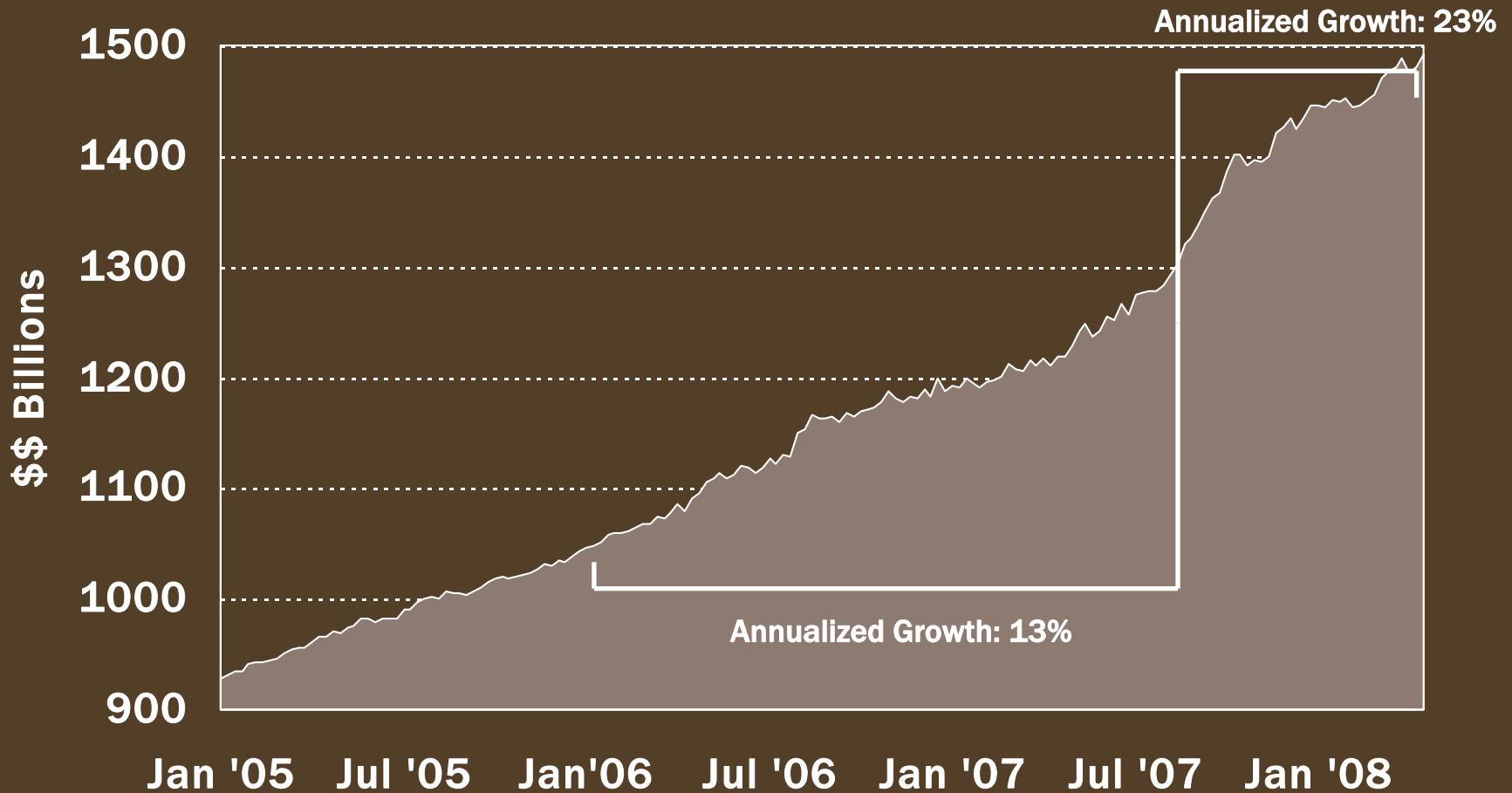
# Issuance of Asset-Backed Securities by Type of Collateral

Monthly, April 30, 2007 to March 31, 2008, (Value for most recent date in parentheses)



# Commercial and Industrial Loans

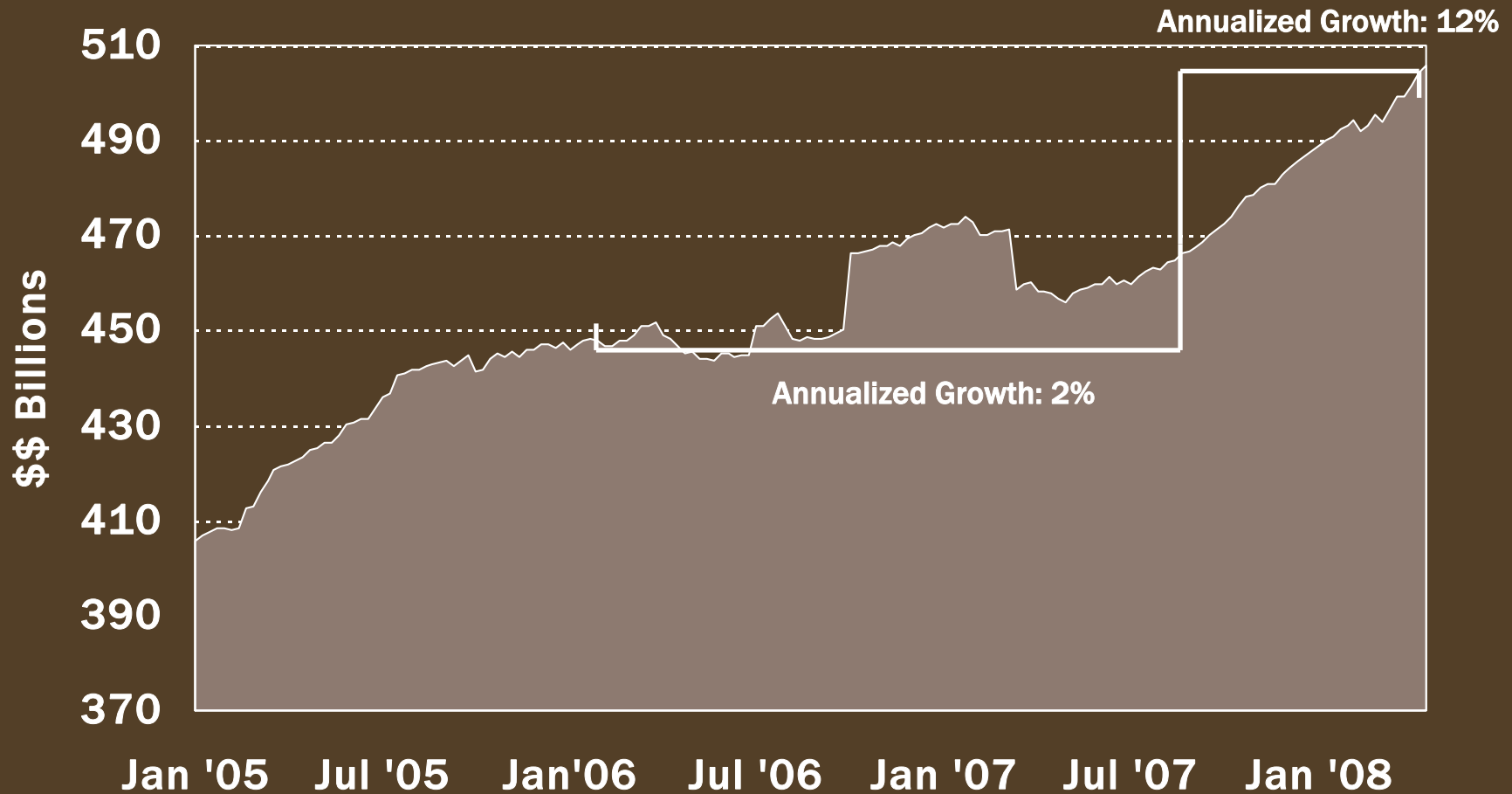
All Commercial Banks



Source: Federal Reserve

# Home Equity Lines of Credit

## All Commercial Banks

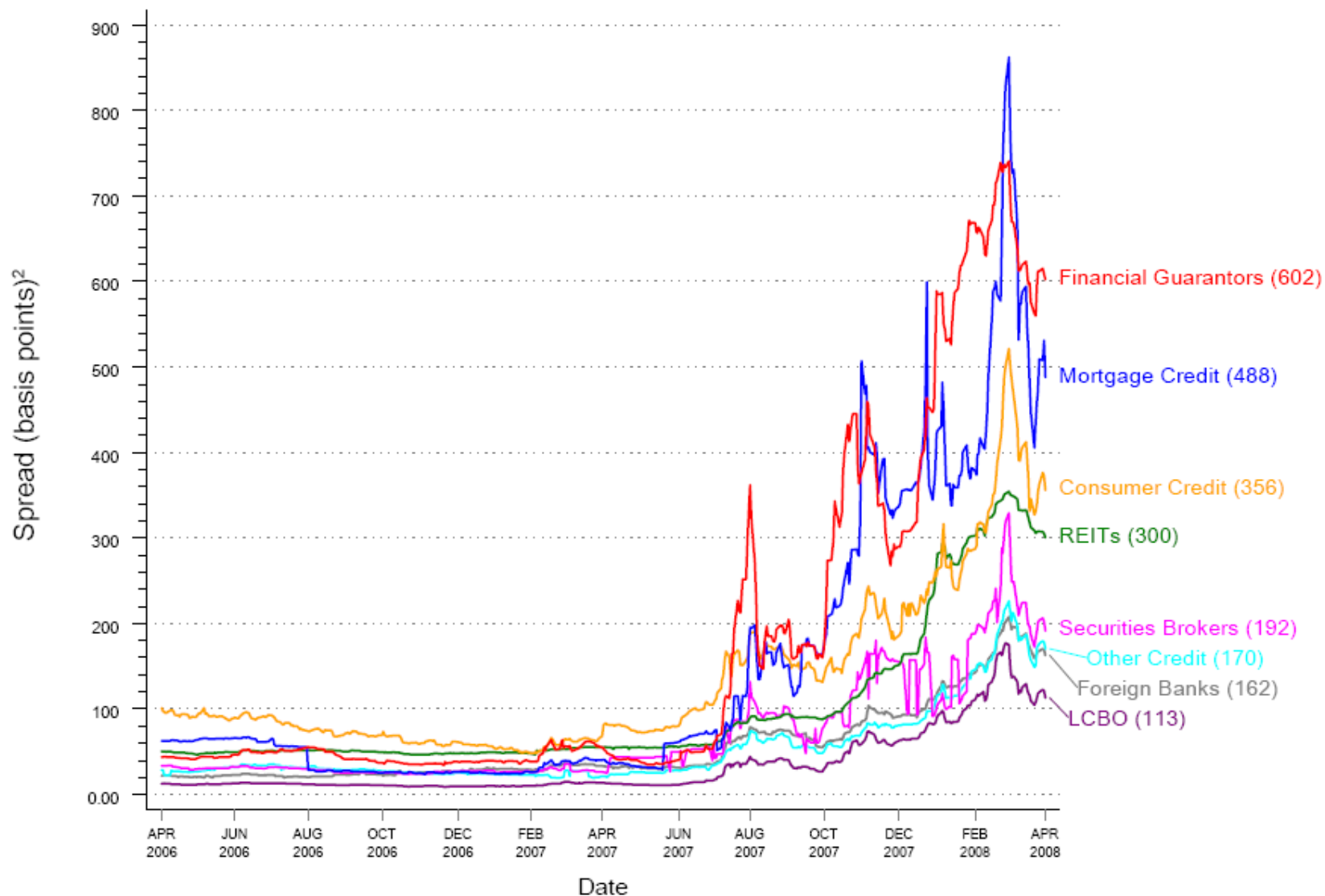


Source: Federal Reserve

# Average Credit Default Swap (CDS) Spread for Financial Sector Industries<sup>1</sup>

Internal

Weekdays, April 16, 2006 to April 16, 2008, (Value for most recent date in parentheses)



# New FRB Programs

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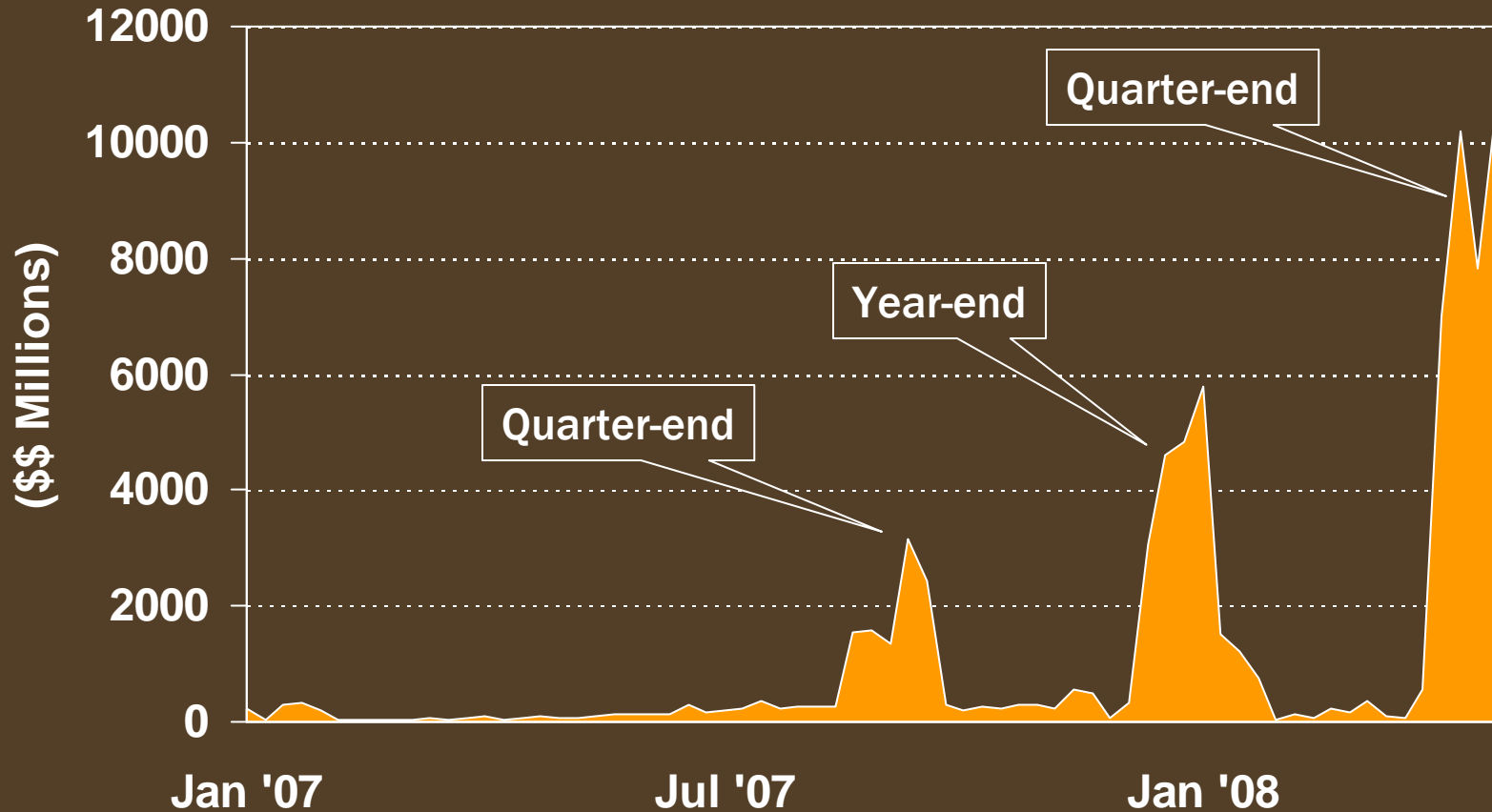
<b>Term Discount Window Program</b>	<b>Same as traditional DW, but borrowing can go up to 90 days</b>
<b>Term Auction Facility (TAF)</b>	<b>28-day borrowings, with price determined by auction</b>
<b>Primary Dealer Credit Facility (PDCF)</b>	<b>Overnight borrowing made available to investment banks, expanded collateral</b>
<b>Term Securities Lending Facility (TSLF)</b>	<b>For investment banks, exchange of Treasuries for a range of collateral for periods of 28 days</b>

[http://www.newyorkfed.org/markets/Forms\\_of\\_Fed\\_Lending.pdf](http://www.newyorkfed.org/markets/Forms_of_Fed_Lending.pdf)

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# Discount Window Borrowing

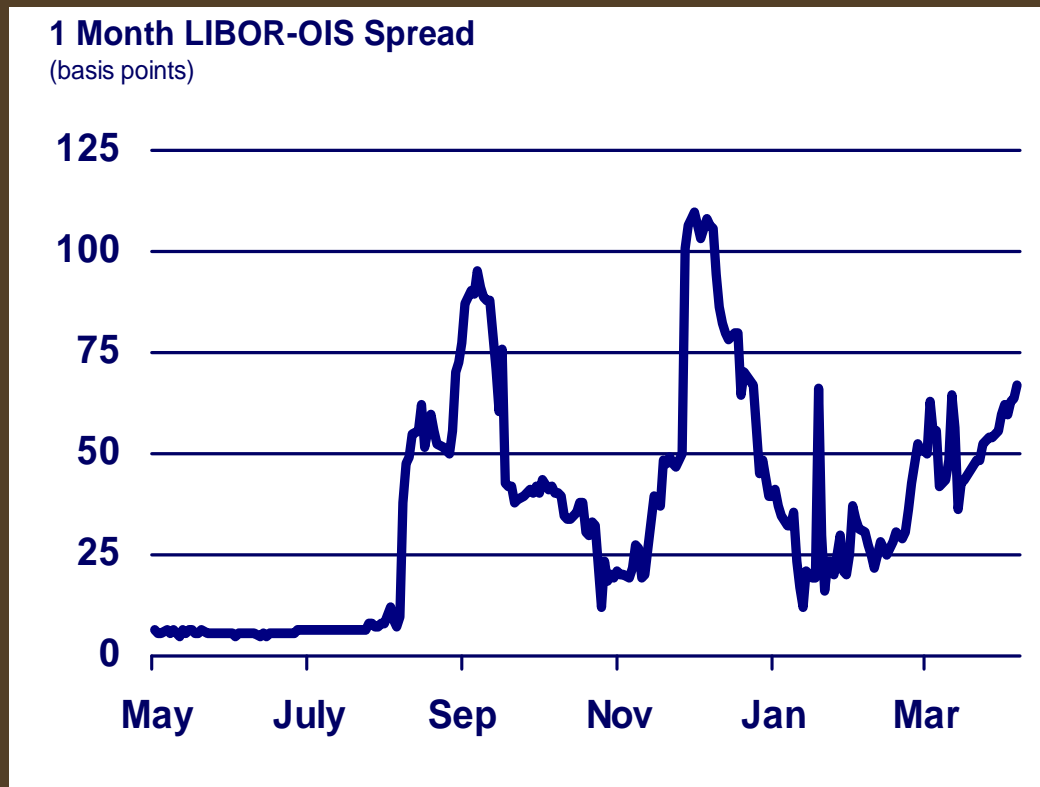
Still Significant



Source: Federal Reserve

# Overnight Funding Conditions: Far From Settled

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- Questions about the quality of LIBOR have arisen

# Bear Market



# Lessons for the Young

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- **Sometimes the skill in using models is knowing when to turn them off**
- **When things go bad, all correlations go to one**
- **Counterparty performance is inversely related to the value of the contract (mortgages, credit default swaps)**
- **You always have plenty of liquidity...until you don't**
- **No amount of capital can protect you from a liquidity crisis**

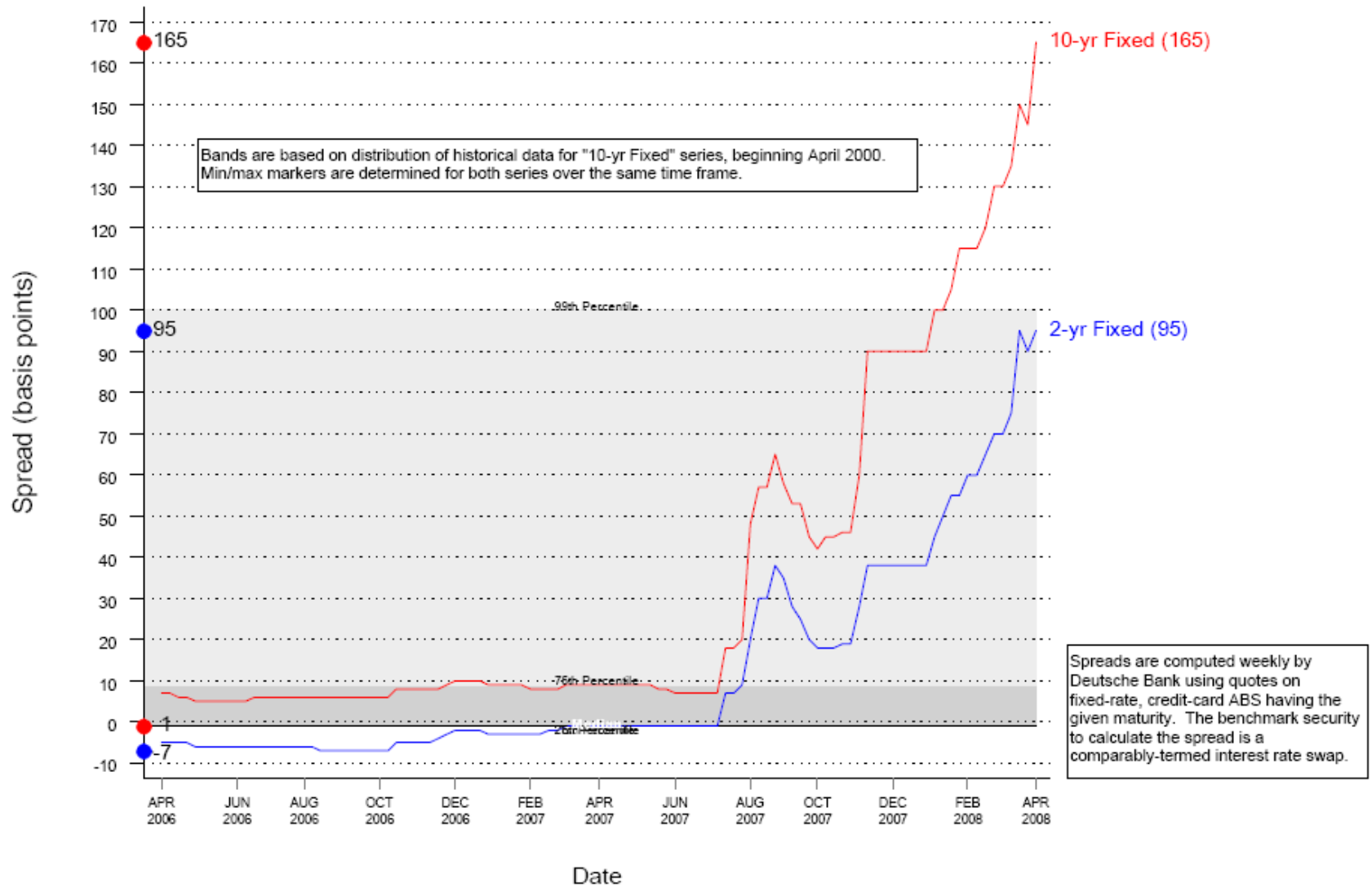
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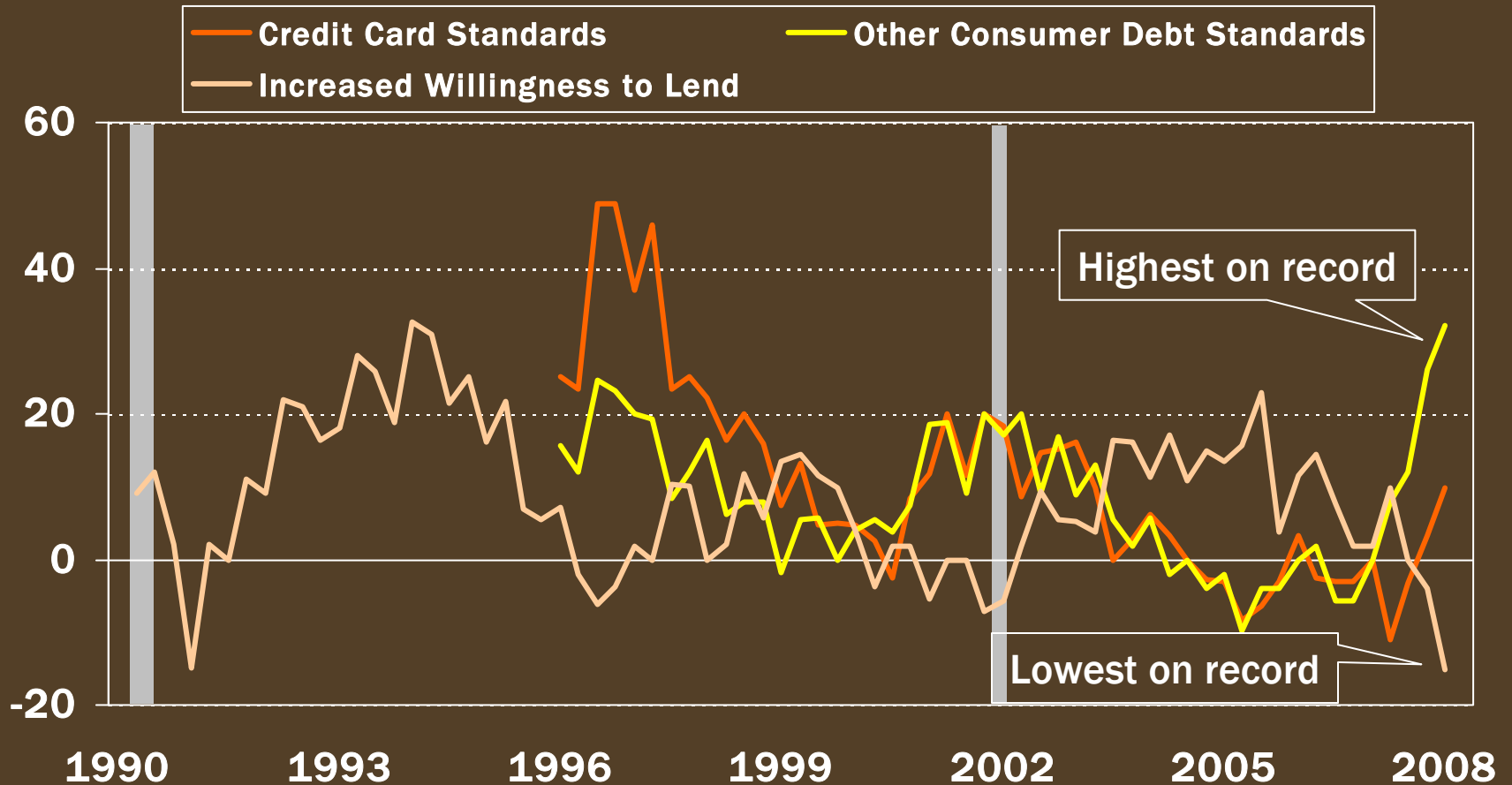
# Spreads on ABS Backed by Credit Card Receivables<sup>4</sup>

Weekly, April 15, 2006 to April 15, 2008, (Value for most recent date in parentheses)



# Senior Loan Officer Survey: Consumer Debt

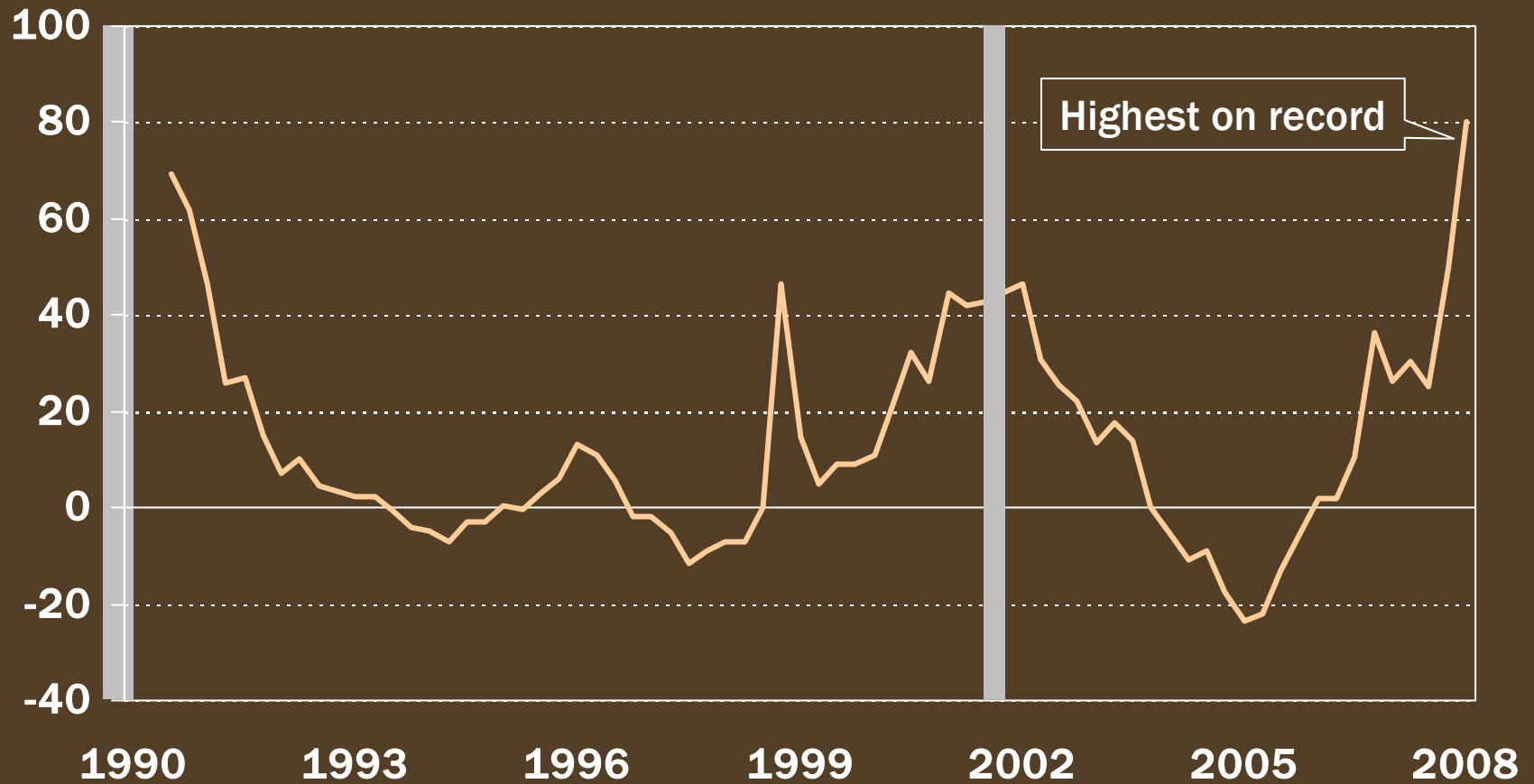
## Net Percentage of Respondents Tightening Credit



Source: Federal Reserve

# Senior Loan Officer Survey: Commercial Real Estate

## Net Percentage of Respondents Tightening Credit



Source: Federal Reserve

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# Some Observations

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- **What we're experiencing is the result of animal spirits, not rational analysis**
- **Leverage capital gains ground against risk-based capital**
  - **New requirements for investment banks?**
  - **Is Basle II in trouble?**
- **Re-regulation is gaining steam; some good ideas, some very bad ones**
- **Liquidity risk is getting renewed (and overdue) attention**
- **Still largely a big bank story, but the trickle-down effect is taking root**
- **Down-side risk is still significant**

# Some Interesting Reading

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- **Senior Supervisors Group, “Observations on Risk Management Practices During the Recent Market Turbulence”**

<http://www.ny.frb.org/newsevents/news/banking/2008/rp080306.html>

- **FRB Governor Kevin Warsh on “Market Liquidity: Definitions and Implications”**

<http://www.federalreserve.gov/newsevents/speech/warsh20070305a.htm>

- **IMF Report on Funding Illiquidity:**

<http://www.imf.org/External/Pubs/FT/GFSR/2008/01/pdf/chap3.pdf>

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