

DAILY GLOBAL COMMENTARY

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Asha G. Bangalore
agb3@ntrs.com

Treasury, Fed, and FDIC Implement New Measures of Support, but Economic Recovery Is Many Months Ahead

October 14, 2008


Treasury, Fed, and FDIC instituted new measures to support the crumbling financial system. The **U.S. Treasury** announced today, October 14, a voluntary program where financial institutions can sell preferred equity to the U.S. government to enhance their capital starved status. Nine major financial institutions have agreed to be part of the program. This capital infusion plan follows the strategy adopted in many of the major European nations. Participating institutions will supposedly prevent unnecessary foreclosures and preserve homeownership. The details of which are not available as yet. The recapitalization program will amount to \$125 billion for these nine banks and an additional \$125 billion will be available to other banks or bank holding companies. Under this program, banks can continue to pay dividends capped at 5% for five years and 9% after this period.

The **FDIC** will provide a 100 percent guarantee for newly issued senior unsecured debt for three years ending June 30, 2012. The guarantee would apply to debt of all maturities issued before June 30, 2009. The guarantee includes “promissory notes, commercial paper, inter-bank lending, and any unsecured portion of secured debt.” The FDIC also guarantees funds, without a limit on size, in non-interest bearing accounts until December 31, 2009. For interest bearing accounts, the guarantee is limited to \$250,000.

The **Fed**, beginning October 27, 2008, will provide funds to businesses under the Commercial Paper Funding Facility (CPFF). The Federal Reserve Bank of New York will finance the purchase of unsecured and asset-backed commercial paper from eligible issuers through its primary dealers. The CPFF will finance only highly rated, U.S. dollar-denominated, three-month commercial paper.

These are the facts of the measures put in place, all details are not available. The entire operation is underway to build confidence, get the credit machine working again and preserve the global financial infrastructure. Here are some related questions and answers (there are many more questions, some with answers, some without):

- (1). Have these actions and those of the counterparts of the Fed and Treasury across the world prevented a recession? No, a global economic recession is nearly certain. The U.S. economy is already in a recession; we are waiting for the National Bureau of Economic Research to make an official announcement. That said, intervention of recent days was necessary to preserve the working of the market. Excesses caused the current crisis and extraordinary measures had to be taken to prevent a systemic collapse. Capital shortage has far reaching implications on the world economy. A financial institution short of capital will suspend lending which appears as smaller credit lines or refusal of credit lines to companies and consumers. In simple terms, every dollar of capital shortage results in a loss of multiple dollars of lending.
- (2). Will the recapitalization of banks solve the problem? Capital was essential but it is not the cure all. First, a thorough and honest audit of financial institutions is essential. The aim of the audit should be to recognize losses, write-down illiquid assets and clean-up balance sheets. Perceptions of counterparty risk will be minimized only if transparency of balance sheets is established.



(3). Does the infusion of capital by purchase of preferred shares dilute earnings? Stakeholders of all hues are paid from the same profit pool. Therefore, there is little doubt that there is a dilution of earnings.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.