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Money markets

Blocked pipes

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When banks find it hard to borrow, so do the rest of us

Illustration by David Simonds

ANY good tradesman will tell you the importance of the bits of a house that you cannot see. Never mind the new kitchen: what about the rafters, the wiring and the pipes? So it is with financial markets. The stockmarkets are the most visible: as they soar or swoon, the headline-writers get to work. The money markets, however, are the plumbing of the system. Normally, they function efficiently and unseen, allowing investment institutions, companies and banks to lend and borrow trillions of dollars for up to a year at a time. They are only noticed when they go wrong. And, like plumbing, when they do get blocked, they make an almighty stink.

At the moment, these markets are well and truly bunged up. In the words of Michael Hartnett, a strategist at Merrill Lynch, "the global interbank market is effectively closed." The equivalent of a run on banks has been taking place, without the queues of depositors seen outside Northern Rock, a British mortgage bank, last year. This stealthy run has been led by institutional investors and by banks themselves.

Many banks have had to be rescued by rivals or the state. This week the Irish government felt compelled to guarantee the deposits and some other liabilities of the country's six largest banks.

Surviving banks have become ultra-cautious—"just taking things one day at a time," says Matt King, a strategist at Citigroup.

The effect has been most dramatic in the overnight rate for borrowing dollars. Bank borrowing costs reached 6.88% on September 30th, more than three times the level of official American rates, while some were willing to pay a remarkable 11% to borrow dollars from the European Central Bank (ECB). Banks have become so risk-averse that they deposited a record €44 billion ($62 billion) with the ECB on September 30th even though they could have earned more than two extra percentage points by lending to other banks. It was the last day of the quarter and, for balance-sheet reasons, banks were particularly keen to have cash on hand. (Overnight rates fell back on October 1st, but one-month rates rose further, indicating that the crisis had not eased.)

In the absence of private-sector lenders to banks, central banks have become vital suppliers in the money markets. With the help of the ECB, the Bank of England and the Bank of Japan, the Federal Reserve agreed to lend a further $620 billion on September 29th (see article). That package, though of similar size to the Bush administration's $700 billion bail-out plan, did not need congressional approval or attract public opposition.

But central banks can only do so much. In particular, they tend to lend for short periods and then only against collateral with a high credit rating. That still leaves banks with the problem of financing their more troubled assets, an issue the Bush administration's plan was designed to solve.

The money markets' difficulties began in July 2007, when two Bear Stearns hedge funds revealed the damage done to their portfolios by subprime mortgages. Since August of that year, central banks have been intervening to keep them functioning, with a series of schemes like America's Term Auction Facility. But the collapse of Lehman Brothers, followed by the long series of rescues in Europe and America, seems to have brought the money markets close to breakdown. Even immediate passage of the Bush plan would not solve all their problems straight away, because it would take time to put the plan into place.

Why do these markets matter? First, the rates on loans paid by many consumers (adjustable-rate mortgages, for example) and companies are set with reference to the money markets. Higher rates for banks mean higher rates for everyone. Second, if the markets are blocked for more than a week some companies may find it hard to get any finance at any price. That could mean more bankruptcies and job losses. Third, more banks could go bust if the blockage continues, making investors even more risk-averse. The downward spiral would take another turn.

"We are at the juncture where more widespread and permanent support is required to restore confidence in the banking sector," say analysts at the Royal Bank of Scotland (RBS). "Without it, the banks will be aggressively trying to contract their books and will be unable to provide credit to retail and corporate clients."

So it is safe to say that, until the money markets behave more normally, the financial crisis will not be over. And until the financial crisis is over, the global economy may not recover.

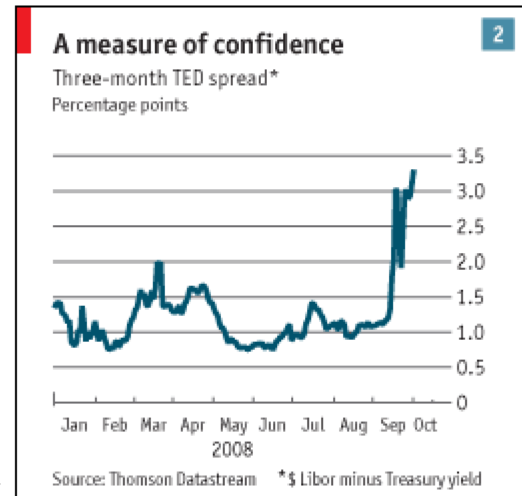
Liquid dynamite

First, the problem. It is widely assumed that central banks set the level of interest rates in their domestic markets. But the rate they announce is the one at which they will lend to the banking system. When banks borrow from anyone else (including other banks), they pay more. Every day, this rate is calculated through a poll of participating banks and published as Libor (London interbank offered rate) or Euribor (Euro interbank offered rate).

Normally, these are only a fraction of a percentage point above the official interest rates. But that has changed dramatically in recent weeks (see chart 1). Take the cost of borrowing dollars. On October 1st banks had to pay 4.15% for three-month money, more than two percentage points above the fed funds target rate. In theory, three-month rates could be that high because markets are expecting a sharp rise in official rates. But that is hardly likely, given the depth of the crisis.

Instead, the width of the margin reflects investors' worries about the banks, not least because so many have faltered so quickly. Three months is now a long time to trust in the health of a bank. In addition, banks are anxious to conserve their own cash, in case depositors make large withdrawals or their money gets tied up in the collapse of another bank, as with Lehman.

One way this risk aversion shows up is in the "Ted spread" (see chart 2), the gap between three-month dollar Libor and the Treasury-bill rate. After being as low as 20 basis points (a fifth of a percentage point) in early 2007, the spread is now 3.3 percentage points. In other words, the relative cost of raising money for banks has risen 16-fold in the past 18 months.



Indeed, some banks argue that Libor and Euribor understate the full extent of the increase in banks' borrowing costs. According to John Grout of the (British) Association of Corporate Treasurers (ACT), banks have started to talk to companies about invoking the "market disruption" clause in loan contracts. This would allow them to replace the two benchmarks with the "real" cost of their funds, which they say would be higher. (Companies usually pay Libor or Euribor plus a margin that depends on the riskiness of their finances.) One company, Hon Hai of Taiwan, an electronics manufacturer, says its banks have already invoked the clause.

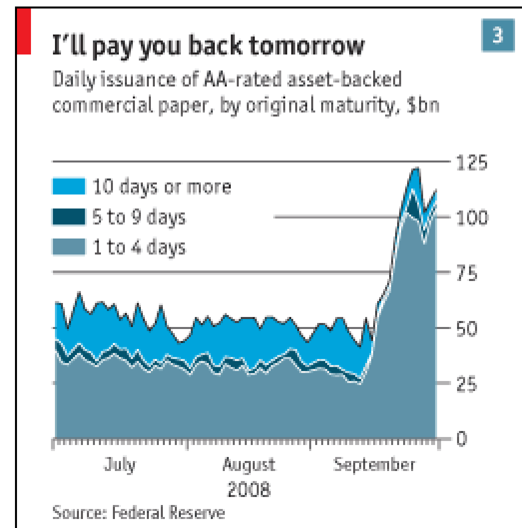
This affects only debt facilities that have already been set up. Mr Grout says that when companies are negotiating new loans with banks, they are being asked to accept rates based on Libor plus a quarter of a percentage point. Unsurprisingly, the ACT is unimpressed with this tactic, since Libor is calculated from data supplied by the banks themselves.

Companies do not have to borrow from banks; they can raise money from the markets by selling commercial paper, a type of short-term debt. For much of this year, that was an attractive option. The preference of investors for debt issued by non-financial companies made commercial paper a source of cheap finance.

But in recent weeks even this has become more difficult. The volume of commercial paper outstanding fell by $61 billion to $1.7 trillion in the week ending September 24th. And investors are unwilling to lend for long: AT&T, a big American telecoms company, said on September 30th that the previous week it had been unable to sell any commercial paper with a maturity longer than overnight. The volume of asset-backed commercial paper maturing in four days or less ballooned from $32 billion a day to $104 billion during September (see chart 3), while the amount maturing in 21 to 40 days fell by 63%.

Where there is doubt about a company's finances, it

inevitably has to pay a higher rate. Worries about GE, one of America's most prestigious companies, pushed up the premium on its credit-default swaps and made raising short-term debt dearer. According to the *Wall Street Journal*, the rate on its commercial paper had gone up by two-fifths of a percentage point. That might not sound much, but GE has $90 billion of paper outstanding, so it faced an extra interest bill of $360m a year. On October 1st the company announced a $12 billion public share offering and a $3 billion injection from Warren Buffett, a leading investor.



Why has commercial paper lost its shine? The explanation seems to lie back in the authorities' willingness to allow Lehman to collapse. That move, designed to warn the markets that the authorities took moral hazard seriously, has had some unintended consequences.

Fund of surprises

The most severe was the loss imposed on the Reserve Primary fund, a money-market fund. Such funds invest in short-term debt and offer investors higher rates than on bank deposits. But they also aim to repay their customers at par. Because it had bought Lehman debt, the Reserve Primary fund was forced to "break the buck" (that is, to repay less than 100 cents on the dollar), only the second such instance in the industry's history. This caused a crisis of confidence in money-market funds. "Prime" funds, which offer slightly above-average rates in return for higher risk, have lost about $400 billion out of $1.3 trillion in the past few weeks, as investors have switched to funds based on government debt. In turn that has made other funds more cautious and led them to steer clear of bank loans and commercial paper.

Buried among the many recent American regulatory initiatives was a scheme to insure money-market funds against failure. That scheme may have halted a stampede by retail investors out of the industry, but it has not restored the level of confidence of two months ago and new deposits do not qualify.

Illustration by David Simonds

At the same time as they are struggling to raise money from outsiders, banks may face more claims on their capital. In the good times they promised to provide back-up loans to companies—which they thought would never be asked for. On some estimates, the value of these promises is $6 trillion. But with the commercial-paper market tightening and the economy deteriorating, more companies will be asking banks to keep their word.

Indeed, companies already seem concerned that banks will be unable to maintain promised loan facilities. So they are using those credit lines earlier than expected, in case they vanish. A prime example is Duke Energy, an American utility, which recently drew down $1 billion from a credit agreement. Chris Taggert of CreditSights, a research group, foresees a "funding blitzkrieg" by high-yield borrowers tapping their

banks for cash if the mayhem does not abate.

“There’s a vicious-spiral element to the inability of companies to roll commercial paper,” says Ajay Rajadhyaksha, a fixed-income strategist at Barclays Capital. “Those that have back-up lines of credit with banks are increasingly drawing on them. This is hurting the banks, and making money-market funds even queasier about buying bank debt, and so on.”

CreditSights notes that it has become more common for companies to call on these loans amid “fears that bank lenders may not be able to honour commitments in the future.” Several of these companies, including General Motors, have cited the uncertain state of capital markets when asking for their money. Goodyear Tire & Rubber said it was drawing down its loans because some of its cash was locked up in, of all places, the Reserve Primary money-market fund.

Whatever the reason, the possibility of more calls from their corporate clients is another factor behind the banks’ desire to hold cash. That will mean any company without a back-up facility may struggle to raise new loans.

Luckily, most companies are not as exposed as they were when the dotcom bubble burst. Nevertheless, plenty of carmakers and retailers have mountains of debt or a strong need for cash. Then there are companies that underwent leveraged buy-outs. The private-equity groups that bought them may have been counting on refinancing their debts soon.

A lack of access to capital is sure to make companies cautious. “Your ability to plan for investment is obviously affected,” says Randall Stephenson, chairman and chief executive of AT&T. In addition, higher finance costs will eat into profit growth, a fact that seems yet to be recognised in buoyant forecasts for 2009. “The equity market is going through the slow process of realisation that a large proportion of earnings growth over the last 25 years was due to the falling cost of money,” says Kit Juckes, an economist at RBS.

Polonius’s revenge

Consumers have been going on a greater debt binge than companies and the impact on them may be more immediate. In particular, they may face higher mortgage and credit-card rates. Some may be denied new credit altogether.

The last survey of senior loan officers by the Federal Reserve was back in July. Even then 65% of banks were tightening their lending standards on credit cards, up from 30% in April. Consumers had not felt the effects by then: credit-card lending rose by 4.75% in the year to July, although other types of credit barely grew at all.

Mortgage costs have also been rising for those with variable-rate loans. On September 30th, American adjustable-rate mortgage rates were 6.13%, according to Bloomberg, compared with 5.92% at the end of August and less than 5.5% in the spring. In Britain three leading lenders raised rates by half a percentage point in the week to September 26th. And Moneyfacts, an information group, says the number of buy-to-let mortgages (used by private landlords) has fallen 85% over the last year.

These effects might teach voters that punishing the banks for their follies is sometimes cutting off their noses to spite their faces. “At some point Main Street will realise it lies on the same road as Wall Street,” says Mr Juckes.

It is not too difficult to imagine bank failures leading to job losses, further falls in house prices,

bad consumer debts and further bank losses. “We may already be at the point where corporate fear and conservatism are baked in: even if things start to improve for the banks, companies have seen how bad things can get, and that can prove lasting,” says Torsten Slok, an economist at Deutsche Bank. “So there is a risk they’ll continue to hoard cash and mistrust banks for quite some time.” That is the kind of spiral which the Bush administration’s plan was designed to avoid.

Relying solely on ad hoc rescues of individual banks would only make investors more nervous about the banks that remain. The financial plumbing would stay bunged up. Unless something is done to unblock it soon, there will not just be a nasty stink in the markets. There will also be an unholy mess in the wider economy.

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