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The Hard Necessity: Funding Failure

“...the FDIC’s immediate need is for more liquid assets to fund near-term failures. If the FDIC took no action... liquidity needs would exceed liquid assets on hand in the first quarter of 2010.”

FDIC Quarterly Banking Profile
Fourth Quarter, 2009

FDIC Chairman Sheila Bair is one of the good guys. She waved her arms early about imminent dangers in the subprime complex, and she has spoken with unusual candor and clarity throughout the financial crisis. Under her leadership, the Federal Deposit Insurance Corporation has navigated through a no-win set of choices without compounding calamity. That’s not to say, however, that their work is done.

The Deposit Insurance Fund (DIF), which guarantees bank and thrift deposits nationwide, fell to a negative \$20.9 billion in the fourth quarter of last year, for a reserve ratio of -0.39%, the lowest level on record. Indeed, it’s in danger of becoming no longer a fund as such (the characterization implies a positive net worth) but rather a conduit to carry money from a \$100 billion Treasury credit line to depositors in failed institutions.

As a stopgap measure to delay that eventuality, the FDIC is requiring insured institutions to prepay 13 quarters of deposit insurance premiums – on a cash flow basis, it is pulling forward more than three years’ future revenues to fund today’s bank failures, which continue apace in 2010.

What’s more, not only has the DIF’s net position gone underwater, but the quality of its underlying assets has suffered – whereas two years ago DIF assets were almost entirely cash and marketable securities, FDIC has had to exchange those liquid assets for claims against the assets of the failed banks it shepherds into oblivion, i.e. it has had to swap cash for illiquid, often problematic assets.

Three years ago ([March 2007 Investment Update](#)), I shared my doubts that burgeoning subprime problems would be quarantined in the grubbier corners of speculation, and contemplated a scenario of sudden illiquidity and systemic lock-up. We’ve since made it through a reality even worse

in its details than the scenario I painted in broad strokes. Yet contamination from those “grubbier corners” still spreads inward from the periphery to the core of our banking structure – the system’s penultimate backstop, the FDIC. How else to describe FDIC’s current predicament? Of necessity, it has adopted the very practices which catalyzed the crisis: swapping liquidity for illiquidity, drawing on future income to spend today, and, absent equity, readying a non-recourse credit facility on the backend. So much for quarantine! It’s a hard irony that to repair bad practices, the FDIC must ape them.

Will this mean the end of deposit insurance, or jeopardy for our bank deposits? No. The Treasury and Federal Reserve (our all-purpose ultimate backstops, sad to say) can agree to expand the FDIC’s credit facility to \$500 billion, an amount which exceeds the combined assets of the 700 institutions on FDIC’s problem list at yearend 2009. And should that list grow, we presume the credit line will likewise grow to accommodate it.

None of which is cause for celebration. Still, funding failures and clearing the deck of wreckage is critical. It will be a long, expensive process, but facing the problems and solving them is better than keeping them in the shadows (see Japan) where they’ll only suck vigor from any recovery.

You may hear hysteria about runaway bank failures and FDIC insolvency in the year to come, Don’t succumb. Failures dealt with are mile markers on the road to recovery.

Follow-up on Last Month

In [last month’s letter](#), I dispensed with the notion that the accounting or sentimental origins of wealth should have any resonating importance for after-tax dollars withdrawn from a portfolio.

To clarify, I meant this as a retrospective attitude: once the dollars no longer reside in the portfolio, their origin is irrelevant; the dollar in our pocket has no memory. Beforehand, when seeking returns within the portfolio, we care very much where the dollars might come from, both in terms of tax treatment and the likely persistence of returns.

My damnation of rearward-looking mental accounting errors was confusing to some of you used to my preaching the virtues of sustainable, dividend-based investing as we manage forward. Summarizing, we regard “the dollar that stays in your pocket” on an *ex post* basis, and manage “the portfolio it leaves behind” on an *ex ante* basis.