Money in the Bank

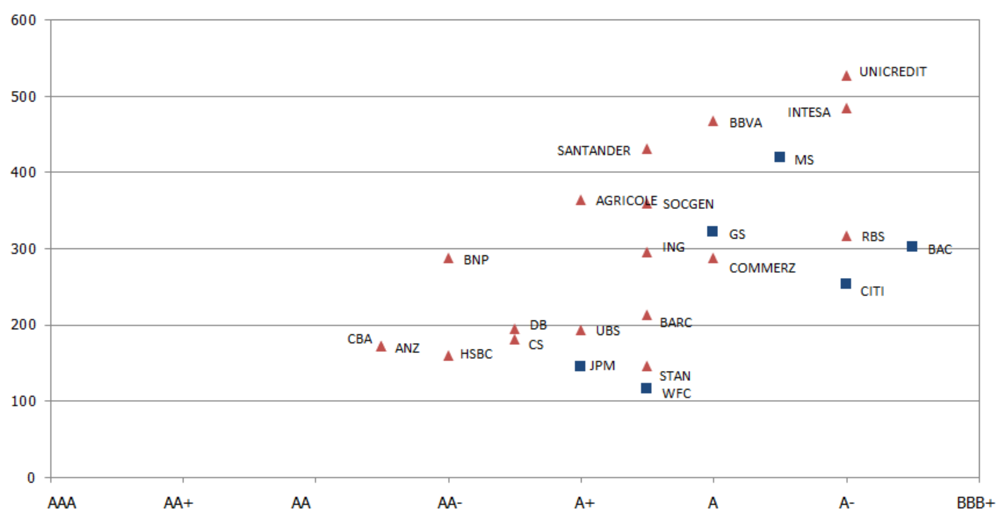
May 2012

Jamie Dimon's stunningly blunt admission that JP Morgan suffered an "egregious" $2 billion trading loss in the firm's Chief Investment Office cast a shadow over the financial sector this past week. Banks, already walking on pins and needles with the pending Moody's downgrades, became a renewed focal point of market participants, politicians, and regulators. Overseas, Spain nationalized its third largest bank, Bankia SA, while instructing other institutions to further bolster their balance sheets by $40 billion. Markets were nonplussed as many estimate actual real estate losses will require double that amount of capital. As the markets struggle to digest the European Union's plight alongside renewed concerns about bank capital levels globally, investors should ensure their counterparty risk is not concentrated and strive to maximize their money management options.

Farewell to the FDIC Guarantee

The FDIC played an instrumental role in soothing the frayed nerves of investors during the credit crisis. It offered unlimited insurance on non-interest bearing deposit accounts (Transaction Account Guarantee, TAG) and provided an explicit guarantee for debt issued under the Temporary Liquidity Guarantee Program (TLGP). At the peak of the program, almost $350 billion in debt was issued with the TLGP guarantee. The last of the remaining TLGP securities are due to mature in December of this year, coinciding with the expiration of the unlimited guarantee as codified in Dodd-Frank. Both programs effectively transformed counterparty/credit risk from that of a risky bank to that of a relatively risk-free U.S. government deposit. This has greatly simplified a credit decision and deadened investor risk perceptions when dealing with banks. The U.S. banking system still faces challenges while Europe sits in the middle of an imploding debt debacle.

Figure 1: CDS vs. Credit Ratings of European Financial (Red) and U.S. Financial (Blue)



Source: Bloomberg

US Treasuries

As of 30-Apr

Benchmark	Yield
3 Month	0.09%
6 Month	0.13%
1 Year	0.19%
2 Year	0.27%
5 Year	0.89%
10 Year	1.98%
30 Year	3.11%

Bank of America/Merrill Lynch Indexes

30-Mar to 30-APR

Index	Return
1-3 Yr Gov/Corp ≥ A	0.19%
1-3 Yr Municipals	0.11%
1-3 Yr Agencies	0.15%
0-3 Month UST	0.00%
S&P 500	-0.63%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

Banks Struggle

Banks, both domestically and abroad, face a challenging environment. Dodd-Frank continues to weigh on U.S. banks as provisions are finalized and enacted. Basel III compliance looms in the future both here and abroad, pushing banks, kicking and screaming, to hold about three times as much equity as they did under the old rules. Measures dictated in order to bolster banks' balance sheets and improve capital ratios should prove to be credit positive. However, bank earnings (especially for the large, supermarket banks) in today's lower leverage and fee environment aren't as easy to generate as in the boom years leading up to 2008. Therefore, efforts to boost capital are complicated by smaller profits, increased borrowing costs, and weak economic activity. Some banks will look to shrink assets further or wind down unprofitable businesses. Ultimately, major U.S. banks will continue the uncomfortable adjustment to a more constrained business environment. Overseas, eurozone banks, already severely behind the curve when compared to their global competitors, will do so amidst the cacophony of the sovereign debt crisis and recessionary pressures.

Recently, the European Central Bank (ECB) provided a $1.3 trillion funding boost to eurozone banks via their Long-Term Refinancing Operation (LTRO). Without action, European banks would have had to face an extremely petulant fixed income market (see Figure 1). As such, many funded their 2012 debt maturities via the ECB and as such we've seen little issuance (actually, the lowest global bank bond issuance in seven years). However, as we now discuss another potential Greek EU departure, the crisis has a certain Lehman-esque quality to it.

The JP Morgan announcement will only heighten uncertainty. Long respected as one of the best run banks in the world, the trading loss (whether it be hedge-related or not) brings the difficulty of managing a large, global financial institution to light. Additionally, it reinforces the reality that risk is prevalent and that concentrating exposure with a small number of institutions is not prudent.

Alternatives

Given the low yields prevalent in the fixed income environment, investors have leaned heavily on their banking relationships boosting bank deposits to over $1.2 trillion (over twice the level seen two years ago). We realize short-maturity fixed income investors have several alternatives available to manage their portfolio needs. The table below lays out the strengths and weaknesses of each. While we have a bias towards separately managed accounts, we do recognize the role each can play within a portfolio strategy. As the investment landscape changes it is imperative that investors reevaluate their options and balance the risks undertaken.

	Separately Managed Accounts	Deposit (Interest Bearing)	Deposit (Non-Interest Bearing)	Money Market Funds	Internal Management
Positives	• Customized • Control • Transparency • Fiduciary requirement • Professional management • Flexibility	• Liquidity • Support banking relationship	• Liquidity • Unlimited FDIC for now • Relatively high earnings credits • Support banking relationship	• Daily liquidity • Stable NAV (for now) • Professional management	• Low cost • Control • Flexibility • Retain decision-making authority
Negatives	• 1-7 day liquidity (not overnight) • Manager risk • Hiring/monitoring process	• $250,000 FDIC insurance limit • Very low yields	• Expiration of TAG • Rising FDIC cost will lower rates • BASEL III rules will lower rates	• Low yield • Commingled risk • Opaque reporting • Suitability requirement • Shrinking investment universe • Portfolio concentration • Lack of control • Pending SEC regulation	• Lack of outside resources/ideas • Low transparency to the market • Hiring/retaining skilled managers • Decision accountability • Dedicating staff time

Source: Clearwater Advisors

Pending SEC money market fund rules (please see our March commentary, **"Credit Check"**) will complicate and significantly alter the nature of money market fund investments. Additionally, the lack of an unlimited FDIC guarantee should give investors pause as they consider earnings credits as compensation for credit exposure. Internal management, while scalable and retaining full control, tends to pose issues with objective performance measurement and talent retention. Separately managed accounts offer many of benefits of money market funds and internal management while diversifying credit risk away from a banking relationship.

Uncertain Future

The high level of uncertainty surrounding two short-term investor mainstays (bank deposits and money market funds) should serve as a catalyst to ensure your portfolio is not overexposed to bank credit or regulatory risk. After a relatively serene first quarter, we expect volatility to increase as global banks adjust to the challenges they face, the European sovereign debt crisis enters a new phase (Grexit, "Greek Exit") and the U.S. economy struggles to grow in the face of fiscal constraints. Be sure to balance your exposure while retaining control and transparency in a separately managed account.

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