

## Price of Fed Failure

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By David Patterson

The market has a price for the failure of the Fed – the failure of the system. While risk has been re-priced over the last few months with many credit spreads rising by 50% to 100% the price the market puts on the risk of Fed failure has gone up 10 times. Since January 1 this year many spreads have actually moderated. The TED spread showing the market's confidence in big banks has come in but the "Fed spread" has continued to rise.

What is this "Fed spread"? It is the spread the market will pay for protection against the total collapse of the system and it can be found in the credit default swap markets.

In these markets a portfolio of 100 different investment grade corporate names might be packaged and then sold in pieces. The first three percent of the losses on such a portfolio might be taken by a hedge fund in return for earning a 20% plus return on the money invested. The losses ranging from 3% to 7% might be taken by another aggressive investor, with the losses from 7% to 10% taken maybe by an insurance company earning an extra spread. All this progresses until the losses from 0% to 100% are assigned to a buyer. Naturally the so-called 'super senior tranche,' which takes all the losses from 30% to 100%, is the largest but it has only miniscule risk. These possible losses are measured after recovery, so a 30% loss would imply 60% of the borrowers have defaulted on their bonds (if the recovery rate is 50%), which is highly unlikely. That is comparable to 300 of the S&P 500 defaulting on their debt. That scenario is a total meltdown of the system – a total failure of the Fed. So the super senior spread is the "Fed spread".

In the credit markets, the super senior buyer is the 'lender of last resort.' But it is exactly this buyer who has disappeared, and that is calamitous. No one is willing to take the system risk although the market still has buyers of individual credit risk. The lingering fear is for a system-wide meltdown. Unfortunately, unless there are buyers of both kinds of risk, the market will not function. In the current market, the price of individual credit risk has gone up a little. However, the market's view of the system risk has gone up ten-fold thereby contributing to the overall cost of credit. The main reason is that no investor is big or strong enough to convince the market that they can sustain the losses of the system as a whole. This is exactly what would happen if there were no deposit insurance and no lender of last resort to the banks. Banks would be immediately in doubt and would collapse in depositor runs. Bank loans would disappear.

To see how extreme the move in the system risk price is look at the CDX.IG.9 30-100% tranche for 7 years. The CDX.IG.9 is an on-the-run index of 125 investment grade bonds. The comparable on-the-run index traded as low as 2 to 3 basis points in 2006 and the first half of 2007. In November this traded out to 26 basis points and now in the last two weeks traded at times as high as 32 basis points.

If the Fed expanded its open market activities to include periodic bids for the super senior pieces of credit structures it could assist the survival of the system without "bailing out" participants at uneconomic prices. By taking the risk of total market meltdown the Fed would be re-instilling confidence in the market. And by taking the system risk it would help the market continue to allocate credit to specific borrowers. Without confidence in the system this process seizes up.

There is another reason for the central banks to take this risk: they already have it. If 50% or more of the investment grade corporates in Europe and America default on their bonds the central banks will have multiple bank failures to deal with. So although other market participants are collecting a huge fee for taking this risk (usually on a 10 times levered basis) it is really the central banks that will be left to guarantee the buyers of the protection in an actual meltdown. The current writers of the risk would not be solvent if markets get bad enough for there to be a claim. So the central banks might as well get paid for a risk that is theirs anyway.

To reverse the price on system meltdown the Fed simply needs to extend its open market activity to provide a bid for the super senior tranche of structures of investment grade securities.

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