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HIGH & LOW FINANCE

## As Bank Profits Grew, Warning Signs Went Unheeded

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We should have known something was strange. The banks were doing a lot better than they should have been doing.

When the history of the financial excesses of this decade is written, that will be a verdict of financial historians. There were signs that banks were either lying about their results or were taking large risks that were not fully disclosed, but investors were oblivious.

What were the signs? Consider how banks make money. They pay low rates on short-term deposits and charge higher rates on long-term loans. So they love what are known as positively sloped yield curves. And they like to see big credit spreads, where risky borrowers are charged much more than safe ones. Put them together, and banks should clean up.

By that light, nothing was going right in 2006 and early this year. The yield curve was inverted, or at best flat. And credit spreads were at historic lows. Risky loans, whether to subprime mortgage borrowers or junk-rated corporations, were readily available at rates that seemed to assume there was only the slightest risk of default.

And yet the bank stocks were buoyant, and so were reported profits.

“We should have been suspicious from the get-go,” said Robert A. Barbera, the chief economist of ITG. “There was financial alchemy at work.”

Instead of being suspicious, many analysts believed that banks had found a new way to prosper. Making a loan and keeping it on the balance sheet until it was repaid was so old-fashioned. It was far better to collect fees for arranging transactions and passing on the risk to others. We did not ask why passing on risks should be so profitable to the risk-passers.

In reality, it was not.

In recent weeks, we have learned of many risks the banks kept. Not only did we not understand them, but there is every indication that senior managements did not either.

Consider “liquidity puts.” Don’t be embarrassed if you have no idea what I am talking about. In a fascinating [article](#) in Fortune, Carol Loomis quotes [Robert E. Rubin](#), now the chairman of [Citigroup](#), as

saying he had never heard of them until this summer.

What were they? Banks put together collateralized debt obligations, or C.D.O.'s, many of which held subprime mortgage loans as assets. The C.D.O.'s were financed by issuing their own securities, and the risk of mortgage defaults seemed to pass to the people who bought the securities.

But we now learn that some banks also handed out liquidity puts, giving buyers of C.D.O. securities the right to sell them back to the bank if there was no other market for them. That risk may have seemed slight when the securitization market was booming. But now the banks are being forced to buy back securities for more than they are worth.

With such a put in existence, I don't understand how the banks could get the original loans off their balance sheets. How could they claim they had sold something if they could be forced to buy it back? It will be interesting to see if the Securities and Exchange Commission challenges the accounting.

But even if the accounting was completely proper, it was not very informative. It does not appear that any banks chose to mention the puts to investors before this month. Citigroup had billions of dollars of them, and in the new quarterly report from [Bank of America](#), we learn that it had \$2.1 billion of such puts on its books at the end of 2006, a figure that rose to \$10 billion by the end of September.

In other words, as the subprime market was starting to falter early this year, the bank stepped up the issuance of such puts. Presumably, that was necessary to "sell" the paper. This week Bank of America announced a \$3 billion write-off. A large part of it came from those puts.

There were many other funny ways to bolster profits, like specialized investment vehicles, or SIVs. These creatures bought those C.D.O. securities, paying for them with money borrowed in the commercial paper market.

Just like banks, the SIVs borrowed short and lent long. The spreads might be thin, but they could employ leverage to make narrow margins go a long way. The SIVs did not have much capital, but so long as everyone believed in C.D.O.'s, they did not need it. The banks that set up the vehicles swore they had no continuing interest in them, and so they also vanished from any balance sheet that investors could see. Now they are costing banks money to prop them up.

[Jamie Dimon](#), the chief executive of [JPMorgan Chase](#), told investors this week that "SIVs don't have a business purpose" and "will go the way of the dinosaur." Will they take the securitization system with them? The answer to that question may be crucial in determining how soon the financial system recovers.

The most important duty of the Federal Reserve is to preserve the health of the banking system. In the early 1990s, after the last big crisis, it engineered a steep yield curve for years, helping banks to recover. When the smoke clears, the Fed will try to do that again, even if it means significantly higher long-term interest rates.

Higher long-term rates are not what either debt-laden consumers or the depressed housing market really

need, of course. But such trade-offs are what come when big risks are taken, and ignored, for too long.

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