

VIEWPOINT

Uncertainty In Credit Markets Challenges Turnaround Pros

By Scott Y. Stuart



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Most people have probably never heard of Douglass National Bank. It was a small regional bank based in Kansas City, Mo. named for 19th century abolitionist Frederick Douglass. Its roots go back to the 1940s and it had just shy of \$60 million in assets. In January, Douglass National achieved the distinction of becoming the first bank in the United States to fail this year.

In every recession or economic downturn, smaller regional banks are particularly at risk of failure. Back in 1989, there were a post-depression era record 206 bank failures in the United States. According to Jaret Seiberg, the financial services analyst for the Stanford Group, a policy research firm, regulators expect to see as many as 200 bank failures nationwide in 2008. While that may not be overly shocking given current economic conditions, it is the story behind the story that is troubling news for both the banking industry and the United States economy at large.

While small bank failures are not uncommon in economic downturns, this economic cycle is different. Perhaps the tremor felt from the failure of Douglass National Bank was a lesson missed and one from which there is still something to learn. It was not until the Bear Stearns melt-down however that the lessons to be learned really came to light.

Between Douglass National and Bear Stearns lies a minefield of regional banks, large commercial banks and in this era, investment banks and trading houses all full of unregulated money from the days of seemingly endless credit and historically low defaults. Those days, now long gone, seem to be that part of a global banking system where failures were not expected and preparedness for the same not assured. More important, however, when Bear Stearns failed, it not only blindsided the Federal Reserve but also gave credibility to economic theories long believed to be pie-in-the-sky as they related to the traditional banking system.

The G-rated version of these theories can be seen in the comments of Federal Reserve Chairman Ben Bernanke regarding the Bear Stearns fallout. In defense of the bailout, Bernanke indicated to Congress the crisis could have ignited a "chaotic" series of chain reactions in the banking system, causing an economic implosion. He further went on to tell Congress that the damage from the Bear Stearns fallout could have been "severe and extremely difficult to contain."

In these dire words however is a vagueness that cries out for closer analysis and dissection. In Chairman Bernanke's attempts to calm the potential for chaos which seems to have been barely avoided in the Bear Stearns bailout, more questions may have been raised than were answered. Was the Bear Stearns bailout aimed at avoiding Depression-era-style panic? Perhaps. But as

turnaround professionals whose livelihood is tightly tied to the credit markets know, panic avoidance alone will not resurrect industries on the verge of total collapse.

Perhaps the R-rated version of what Chairman Bernanke was really trying to impart to Congress was what former Federal Reserve Chairman Greenspan called the cascading theory of cross defaults. Very simply put, this is the theory which

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studies the effects of the inability of the banking system to clear accounts from each other. In other words, given the complex interrelationship between banks, and in this era interplay with investment banks and trading houses, the failure of one can collapse an entire system based mostly on the chain reaction resulting from defaults in payments owed from one institution to another.

This seems to be what Chairman Bernanke was really referring to. And if it is, then what is really at risk is far greater than a bunch of regional bank failures, otherwise typical of a down economic cycle. The ability to raise real capital to keep various industries afloat, how to move away from risk adversity with any level of comfort and how to create fail safes which assure confidence in the banking and investment sectors may be the new area of focus for restructuring and turnaround professionals.

The questions raised by bank failures from Douglass National to Bear Stearns alike go to the very core of the United States banking system and economy.

If, as Chairman Bernanke indicates, "credit...is the life blood of the economy," will the unwillingness of top-tier institutions like Citigroup and Washington Mutual to lend because of their own write-downs and balance-sheet issues unintentionally trigger the cascading defaults that appear more likely to occur? Is there any way to truly fail safe the banking system from cascading cross defaults and the fallout that may result?

And on a broader scale, will the squeeze on credit from the top end of the banking system not only impact on regional banks, but industries currently viable and in need of credit, but unlikely to get it?

These are all complex and troubling questions that go to the core of the United States economy, particularly as regional economic woes fester as a result. For turnaround professionals however, while the prognosis of a busy time seems to be a certainty, the diagnosis for renewed life in many industry sectors is not.

All this being said, the near-disastrous fallout from the Bear Stearns failure may act as the impetus for expanded (and necessary) regulation in the banking sector. As Tim Geithner, president of the New York Fed, recognized, there is an elaborate relationship between the likes of mid-sized players such as Bear Stearns and thousands of banks and hedge funds. In this recognition lies a deep-seated fear of what the failure of the mid-size player may mean to the rest of the economy, something neither studied nor thought of in the recently ended high flying liquidity era.

Turnaround professionals will struggle with how to save businesses, if not entire industry sectors, while policymakers work to prevent a deepening credit crisis. Hopefully, the bailout of Bear Stearns was not just a rude awakening to what could have been, but the first step towards paving the way to preventing broad based cascading defaults and global economic failure. If that results in confidence in the banking system, credit will again become more widely available and the economic tide should begin to turn.

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