The Fed Officially Kicks Off the Next Recession

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by Robert McHugh, Ph.D.

It is official. A recession is coming. How do I know? Because this week new Fed Chairman Ben Bernanke gave an official warning to bankers about commercial real estate loans. That is always the kickoff to a recession. It is the starter's gun, the national anthem before a ballgame, the opening hymn at a church service. Here is how it works. The Fed has three official tools to control the money supply: Setting reserve requirements (telling banks how much of their deposits they cannot lend. The higher the reserve requirements, the less loans, the less money creation by the economy). The second tool is open market operations. Here they set the amount of money in the system by buying or selling securities. Third is setting the discount rate, the rate of interest banks must pay to borrow money at the Fed. Theoretically, the higher the rate, the less money banks will borrow, the less they have to lend, and the less money that is created by the banking system.

However, there is ***a fourth tool, a stealth tool***, which has more power and impact than the other three. It is called the Federal Reserve Bank examiner. He/she is the person who goes into a bank about once a year and decides which loans are good and which are bad. Based upon their holy edict, a loan is classified in one of several categories which determines how much money the banks must set aside from earnings to reserve for possible losses. It is completely an estimation game. So the rules can and do change, based upon the whims of the examiner, taking his marching orders from the Fed Chairman. If the Fed wants the money supply to expand, then Fed examiners come in with reasonable standards for review of loans, and classify those loans with a general leaning that they will be repaid according to terms. Thus banks do not have to reserve as much for possible estimated losses and are in effect not discouraged from making more loans. When the Fed wants money supply to grow, aggressive lending standards often get passing grades. That's when you business people will see your friendly bank commercial lender more often, jawing you into that expansion project you've been thinking about, inviting you to golf outings and ball games. They want more loans. They need your expansion project.

However, ***once the Fed Chair sounds the alarm about commercial real estate loans, it starts an entire chain of events that ultimately and unequivocally leads to economic recession.*** Here's what happens. Out of the blue (that seems to be a favorite modus operandi for all Fed operations) those friendly back-slapping Federal Reserve examiners (not really, they are never overly nice — okay I've met two or three out of a pool of three hundred — Mike, Eddie, Eric, you know who you are and I know you read my stuff) show up with a scowl that droops like the golden arch. They ask for the files, a table, an outlet, a coffee pot, and the key to the little boys and girls room. About two days after they arrive, the banker knows something has changed, something serious, and he gets this knot in the pit of his stomach that will last for about three years. Examiner Margo asks for a meeting with banker Joe. She brings her supervisor to raise the fear level of the meeting. The Bank's President, Joe, brings his top commercial lender for protection of his fanny, and that lender brings his junior lender who will ultimately be the sacrificial lamb and get the ax should things blow up.

Bottom line: ***Margo feels that a good commercial real estate loan, paying on time, plenty of collateral, doesn't quite throw off enough cashflow on its financial statements in file, and is now suddenly rated below satisfactory.*** Not quite doubtful. What this means is the banker now has to set aside 20 percent of the loan in reserves for possible losses. ***That reduces income, and he has a big one-time hit coming to earnings this quarter.*** The banker defends the loan with dexterity — he has to fight back, but cannot tick them off too much as they hold all the cards — but the discussion is going nowhere. Finally Margo's supervisor, Lead Examiner Harry, whose head hasn't moved an inch — just his eyes, rolling back and forth from speaker to speaker — drones out, "This loan is less than satisfactory," then gets up and goes back to his room full of tables, laptops, and loan files. This goes on for days.Toward the end of the examination, about a month later, they bring out the heavy artillery. ***More senior examiners from the regional office arrive and the meetings get larger and longer as satisfactory loans have now been declared doubtful, and doubtful loans are now downgraded to total loss. They especially target commercial real estate loans***. First ones to go.Again, nothing regarding the loan itself has changed, the game is one of judging the subjective quality of the loans, and ***for no apparent reason, the subjective quality of myriad loans has remarkably deteriorated.*** The banker is left with a list of suddenly crappy loans in his portfolio, and a required loan loss reserve that is about 80 percent higher than he has on the books. He is then told in a wrap-up meeting that because of this "loan quality problem" in his bank, his bank's overall rating has been dropped from a 1 to a 2 or a 2 to a 3 (banks are rated 1 to 5 with 1 being the best. Ratings below "2" get bank presidents fired. Ratings below 3 get the Chairman of the Board of Directors removed, with lots of fearful warnings to the Board of Directors of the bank about Director liability and civil money penalties). This rating is confidential, with criminal prosecution should the banker reveal it. In fact everything in the examination report is confidential, with criminal penalties should he reveal its contents.There is no appeals process.

Needless to say, after the examiners pack up their newspapers, laptops, and locked suitcases, the banker and his crew of commercial real estate lenders are left in shock. The Board of Directors gets a visit about a month later from the Head examiner and the top Regulatory folks at the regional Fed office. If they bring someone from "Washington D.C.," then the bank President and Senior Lender are toast. The Board of Directors politely listen as the Head Examiner and his boss cite every blemish and foul found in the place with smiles intermittently flashed with icy stares, a game of intimidation. Warnings are given, then the Fed folks get up, make sure they shake everybody's hand in the room as if its "business, not personal," and leave.

At the end of the day, a junior lender gets canned, the Board steps up the heat on the President to do something about this, and ***banker Joe and his senior lender immediately decide to stop making commercial real estate loans.***

For the economy, this means ***a credit crunch has started***. Expansion stops. Willing buyers can no longer obtain financing to buy properties. This reduces demand for properties at the exact same time bankers are encouraging these suddenly classified borrowers on their books to sell their properties and pay back the loans. This increases the supply of properties for sale at the exact wrong time, lowering prices.

But the black hole is just getting started — just beginning to suck the economy into the abyss. What I outlined above is merely round one.

About six month later, ***property values have dropped from this excess of supply and lack of demand due to the curtailing of bank commercial real estate loans***. This means the collateral values of the loans on the bank's books have declined.

Another Fed examination is scheduled, they are back in, and with the battle well under way, it is time for these public servants to start shooting the wounded. They are fully aware that property values have dropped, and — ignoring the fact that *they* caused them to drop — they march to the file room, grab their favorite previously classified loans, and get to work. They assign the most experienced examiners to review the classified loans while they send the rookies to find potential problems among the previously good loans. But the action is with the classified bad boys.

That loan they rated less than satisfactory because of cashflow problems the last time they were in has now deteriorated to doubtful because of the compounded affect of collateral undervaluation. That means instead of setting aside 20 percent of the loan amount into the reserve for possible losses, banker Joe must now set aside 50 percent, another big hit to earnings. He had promised the Board of Directors that last year's one-time hit for potential loan losses would be a one-time occurrence. He realizes that is not the case, and begins to wish he had become a UPS delivery man.

At the end of the day, the bank's rating has dropped, the Board is scared about Director liability, and Joe is pulling out every political favor he's accumulated among a majority of the Board to keep him around for one more year. He agrees to sacrifice the bank's Senior Lending officer, who has served as a shield the past year, not making loans, but sitting in his office, ready to be ejected for the good of banker Joe's considerable stock options portfolio and other bennies that come with holding on to a bank presidency for a decade or so. The senior lender is replaced by a credit hack, someone with no people skills, adept at strong-arming bank borrowers into paying back the money. The goal is to shrink the loan portfolio by not making new ones, using the normal cashflow from payments to reduce outstandings, and to sell at a discount or coerce partial payments from existing loan customers who were rated unsatisfactory by the Federal Reserve's finest. This means lawyers get involved, lots of lawyers, skilled at scaring borrowers into "working out" loan repayments with this new nasty bank lender. ***This means less money is available for potential buyers of property in the economy, more distressed sale supply hits the market, and real estate values fall even further.***

It is about now that everyone recognizes a recession is well underway, led by a real estate collapse. The truth of the matter is, the rules were changed by the Fed and nobody was told until it was too late, and the economy plunges.Voters scream, a few politicians get tossed, and the phrase "credit crunch" becomes a darling of the media. It takes action by the President of the United States to haul in the Federal Reserve Chairman, and explain to him the reality of the reappointment process every four years. Suddenly, at the next bank exam, a new friendlier, examination teams shows up, drinks more coffee, has a few extra newspapers tucked next to their laptops, are asking for fewer files, complain they have to rush to another job in two weeks so won't be there as long as the last time, and leave with little fanfare. The bankers are told in the wrap-up meeting, that they've improved their loan quality, the bank's rating is boosted one grade, and all is well with the world — end of recession.

On March 8th, 2006, Federal Reserve Chairman Ben Bernanke announced at the Independent Community Bankers of America conference, "The rapid growth in commercial real estate exposures relative to capital and assets raises the possibility that risk-management practices in community banks may not have kept pace with growing concentrations and may be due for upgrades." Fed examiners are warming up their laptops. The barbarians are headed for the gates.

The Fed announced <u>again</u> on March 9th, with no palatable explanation, that they will no longer publish M-3 as of March 23rd. While they claim that M-3 is useless, in the blurb on their website, the fact is banks are still reporting all the data on their Call Reports used to calculate M-3. The Fed has not eliminated the unique M-3 components from the Bank Call Reports.

Why don't they want to be transparent with the most important statistic, the very measure of why they were established by a minority of Congress during a late night session back in 1913? Because they cannot wait to pump money to high heaven like some sort of fiat tower of Babel.

M-3 was increased by $28.3 billion last week, a 14.2 percent annualized rate of growth. ***Over the past 2 weeks, M-3 was boosted an amazing $81.9 billion, for an annualized rate of growth of 20.7*** percent! Over the past 8 weeks, M-3 is up 129.6 billion, an 8.2 percent rate of growth, and is ***up a whopping $249.7 billion over the past 12 weeks, a 10.7 percent annualized rate of growth, a $1.0 trillion annual expansion.***

What is happening here? How does this reconcile with the Bernanke announcement that bank commercial real estate lending will be curtailed?

There are two ways for the money supply to grow. First is through the bank lending function. The more lending, the more spending, the more bank deposits, which is at the core of the money supply definition. The Fed has apparently decided to slow the velocity of money creation by slowing or shutting down lending. However, the Fed knows it needs money to buy financial markets and monetize our debt. ***The lending function is too much out of the direct control of the Fed. In other words, money is created that***

way, however the Fed doesn't get to decide where that money goes. It is going to businesses for expansion and jobs, etc… No, ***the Fed wants to decide where money goes***. So it will replace money created through the lending function with money created from thin air by the Fed itself. The way for that electronic money to enter the economy will be from the Fed directly buying something, or lending money to someone. ***In effect, the Master Planners will decide where fresh money goes. They will control more of the spending. But they cannot let us know this***. Because it would be too easy to prove they are doing this if M-3 remains transparent.You would simply compare commercial and consumer loan data to the M-3 figures. ***If we saw debt declining but M-3 rising, voila, we would clearly see the Fed is directly pumping and funneling that money someplace, which would beg the tough question, where?*** You can bet most honest, patriotic, free-market Americans would not appreciate the answer.

"For there is one God, and one mediator also between
God and men, the man Christ Jesus,
who gave Himself as a ransom for all,
the testimony borne at the proper time."

1 Timothy 2:5, 6

Robert McHugh Ph.D. is President and CEO of Main Line Investors, Inc., a registered investment advisor in the Commonwealth of

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