March 16, 2009

Collateral, Damaged

Some continuing e-comments of SK*advisors* - By: *J. Roger Shealy, CPA*
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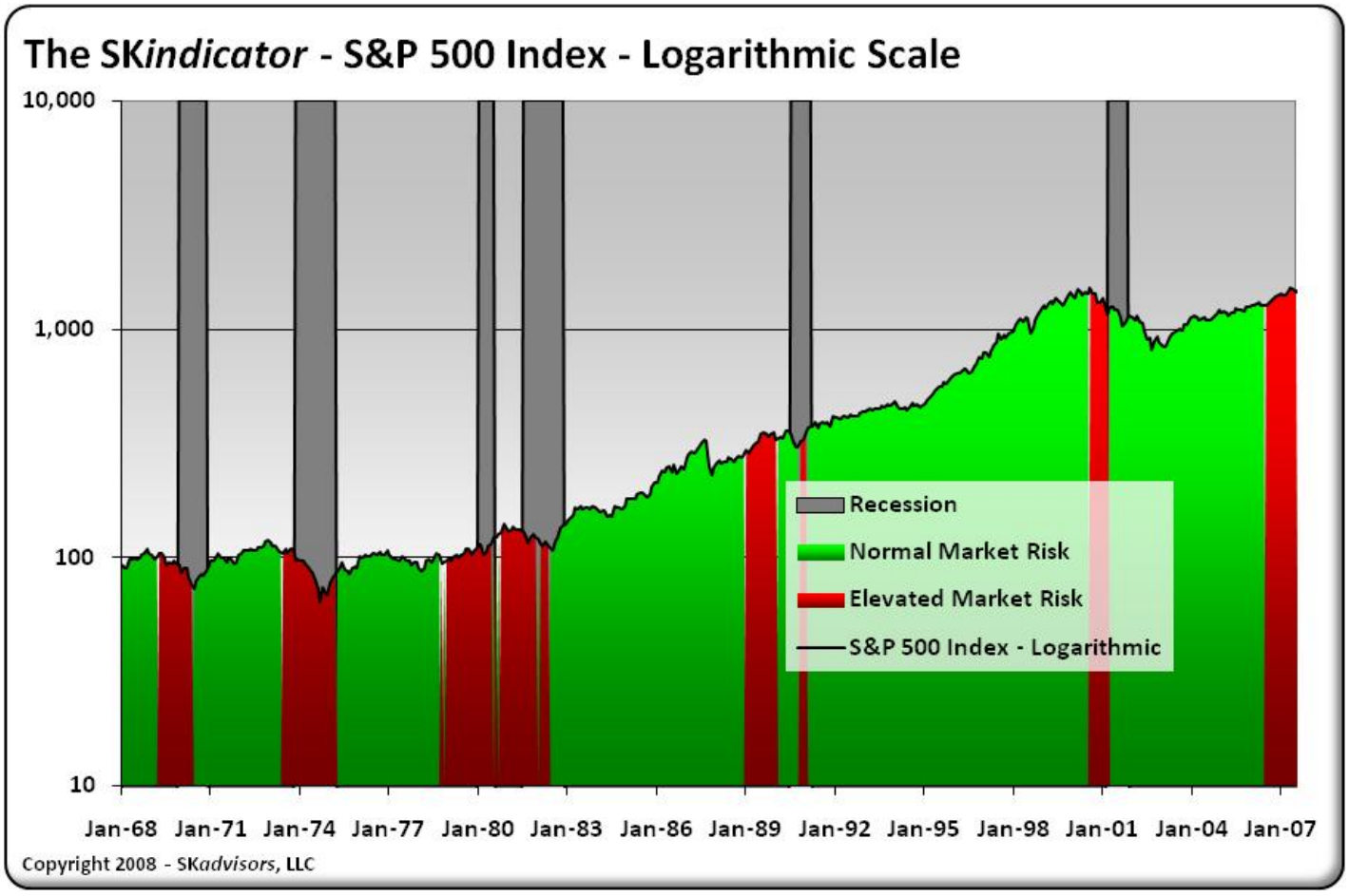
We track a lot of macroeconomic data here at SK*advisors*. We do so, primarily, to measure changes in the business cycle, which helps provide a basis for investment selection and decision making. Though there is no crystal ball, having a sense of where we are in a business cycle is valuable information and can act as a guide when it comes to portfolio allocation.

Many of you will remember the letter from August 2007 where we rolled out a copy of the SK*indicator*. At that time our indicator was signaling a high risk of economic recession and indeed, as we now know, a recession was officially declared as of December 2007. A copy of the SK*indicator* at that time follows:



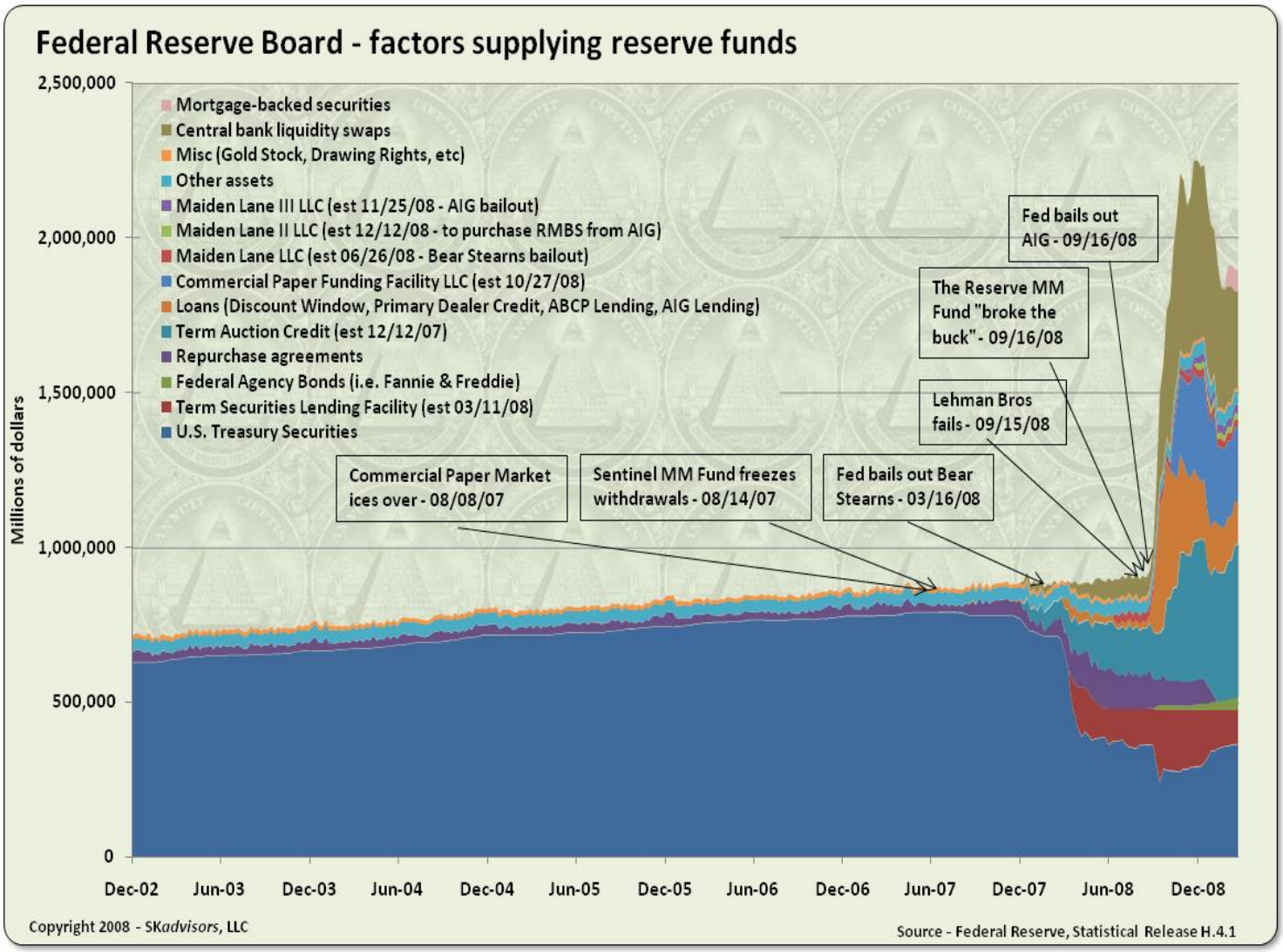
There are a number of components to the above SK*indictor* - and similar to the Leading Indicator provided each month by The Conference Board, we track money supply as one of those components. But unlike The Conference Board, which simply uses M2 as its measure of money supply, we track a number of subcomponents of M1 as well as government deposits which seeks to provide a more accurate picture of funds immediately available for spending.

What I wish to highlight today, however, are some fundamental changes that have occurred as our government (especially the Federal Reserve) continues to work through its stimulus and bailout programs. Though these changes are significant and are the direct consequence of the Fed's recent activities; they are not being discussed nor are their implications being considered.

As the Fed began to shift from open market operations to quantitative easing (or "credit easing" as described by Chairman Ben Bernanke), they have used their balance sheet to provide liquidity to cash-strapped financial institutions and illiquid markets such as mortgage-backed securities, financial commercial paper, asset-backed commercial paper, etc. The way this works (in simplified form) is the Fed makes a loan (thus increasing their assets) and records a liability (the bank credit provided). On the one hand, the effect is similar to open market operations where the Fed purchases Treasury securities and pays for it by increasing the bank credit for that dealer (money creation) – however, it is different in that these are "loans" to financial institutions not the outright "purchase" of securities.

NOTE: There are a few exceptions as the Fed has recently established a number of Limited Liability Companies which it "lends" to and the LLC subsequently "purchases" various assets….of questionable quality, I might add.

Whether lending or purchasing, the Fed expands their balance sheet by increasing assets and increasing liabilities (bank credit). To see just how significant these efforts have been, consider the following chart which shows assets of the Federal Reserve. Notice the change in asset composition and sheer increase in amount.



To further illustrate, the following is the Balance Sheet of the Federal Reserve and it shows the changes that have occurred since January 2007. There are three things I wish to draw your attention to, with the last being the focus of this letter. First, the items highlighted reflect the new programs established by the Fed to meet the liquidity demands of financial institutions and to deal with the credit crisis in certain markets and individual companies. As you can see, these efforts are massive (you can compare the balance sheet with the chart above for perspective). Indeed, these actions by the Fed are unprecedented in the history of our central bank.

Consolidated Statement of Condition of All Federal Reserve Banks

Millions of dollars

	3/11/2009	1/3/2007	Change	Percent
Assets				
Gold certificate account	11,037	11,037	-	0.0%
Special drawing rights certificate account	2,200	2,200	-	0.0%
Coin	1,835	797	1,038	130.2%
Securities, repurchase agreements, term auction credit, and other loans	1,215,866	819,922	395,944	48.3%
Securities held outright	588,052	778,910	(190,858)	-24.5%
U.S. Treasury securities	474,662	778,910	(304,248)	-39.1%
Bills	18,423	277,019	(258,596)	-93.3%
Notes and bonds, nominal	412,914	467,864	(54,950)	-11.7%
Notes and bonds, inflation-indexed	39,378	30,105	9,273	30.8%
Inflation compensation	3,947	3,922	25	0.6%
Federal agency	44,432	-	44,432	
Mortgage-backed securities	68,958	-	68,958	
Repurchase agreements	-	39,750	(39,750)	-100.0%
Term auction credit	493,145	-	493,145	
Other loans	134,669	1,262	133,407	10571.1%
Net portfolio holdings of Commercial Paper Funding Facility LLC	240,858	-	240,858	
Net portfolio holdings of LLCs funded through the money market investor funding facility	-	-	-	
Net portfolio holdings of Maiden Lane LLC	26,178	-	26,178	
Net portfolio holdings of Maiden Lane II LLC	18,427	-	18,427	
Net portfolio holdings of Maiden Lane III LLC	27,597	-	27,597	
Items in process of collection	604	5,472	(4,868)	-89.0%
Bank Premises	2,186	1,945	241	12.4%
Central bank liquidity swaps	312,461	-	312,461	
Other assets	41,738	37,152	4,586	12.3%
Total assets	**1,900,987**	**878,525**	**1,022,462**	**116.4%**
Liabilities				
Federal Reserve notes, net of F.R. Bank holdings	862,265	781,347	80,918	10.4%
Reverse repurchase agreements	66,385	29,742	36,643	123.2%
Deposits	915,585	26,529	889,056	3351.3%
Depository institutions	632,490	20,044	612,446	3055.5%
U.S. Treasury general account	34,431	6,156	28,275	459.3%
U.S. Treasury, supplementary financing account	199,945	-	199,945	
Foreign official	1,793	90	1,703	1892.2%
Other	46,926	239	46,687	19534.3%
Deferred availability cash items	3,720	4,840	(1,120)	-23.1%
Other liabilities and accrued dividends	9,124	5,461	3,663	67.1%
Total liabilities	**1,857,079**	**847,919**	**1,009,160**	**119.0%**
Capital accounts				
Capital paid in	22,360	15,328	7,032	45.9%
Surplus	20,947	15,029	5,918	39.4%
Other capital accounts	601	248	353	142.3%
Total capital	**43,908**	**30,605**	**13,303**	**43.5%**

Note: Components may not sum to totals because of rounding

Secondly, and most obvious, is the growth of assets and liabilities. Again, this is the expansion of the central bank's balance sheet described above and is the result of the Fed's "Credit Easing" policy implementation. As the Fed creates a loan (an asset) it also creates bank credit (a liability) – and that bank credit is primarily reflected in the Deposits of Depository Institutions as shown above.

Note: Some of the programs and policy issues listed above have been discussed in the past two letters (Paper or Plastic? and Keeping it Clean). While there are many topics of discussion from the data already presented, I wish to jump off at this point and discuss the third observation.

Thirdly, please look again at the above balance sheet and notice the asset section titled Securities held outright. These assets are referred to as the System Open Market Account (SOMA) and are used by the Fed to conduct open market operations (see Keeping it Clean for a detailed discussion of the SOMA). Here is that section shown separately:

SOMA Holdings

millions of dollars as of:	1/3/2007	% of Total	3/11/2009	% of Total	Change	% Change
Bills	277,019	35.7%	18,423	3.15%	(258,596)	-93.3%
Notes and bonds, nominal	467,864	60.4%	412,914	70.69%	(54,950)	-11.7%
Notes and bonds, inflation-indexed	30,105	3.9%	39,378	6.74%	9,273	30.8%
Federal agency	-	0.0%	44,432	7.61%	44,432	-
Mortgage-backed securities	-	0.0%	68,958	11.81%	68,958	-
Total	774,988	100.0%	584,105	100.00%	(190,883)	-24.6%

As stated by the Fed, the securities in this account (SOMA) serve three primary purposes:

- Collateral for U.S currency in circulation and other reserve factors that show up as liabilities on the Federal Reserve System's balance sheet
- A tool for the Fed's management of reserve balances (open market operations)
- A store of liquidity in the event of an emergency need for liquidity arises

It is this first purpose, and in my opinion the most important purpose, I wish to highlight – **Collateral for U.S. currency in circulation.**

Just as the Fed's Balance Sheet has changed, due to the "Credit Easing" policy implementation, so has the SOMA – and since the assets in this account serve as collateral for the dollar, it is important that these assets be of the type and quality that constitute the "full faith and credit of the United States government." Yet what we have seen occur has been absent from debate; in fact, it has not even been discussed.

Each week the Federal Reserve releases a report entitled "Factors Affecting Reserve Balances." This report includes the information presented above, as well as, a table (Table 10) which details the collateral held against Federal Reserve notes (currency). The following is what that table looked like on January 3, 2007.

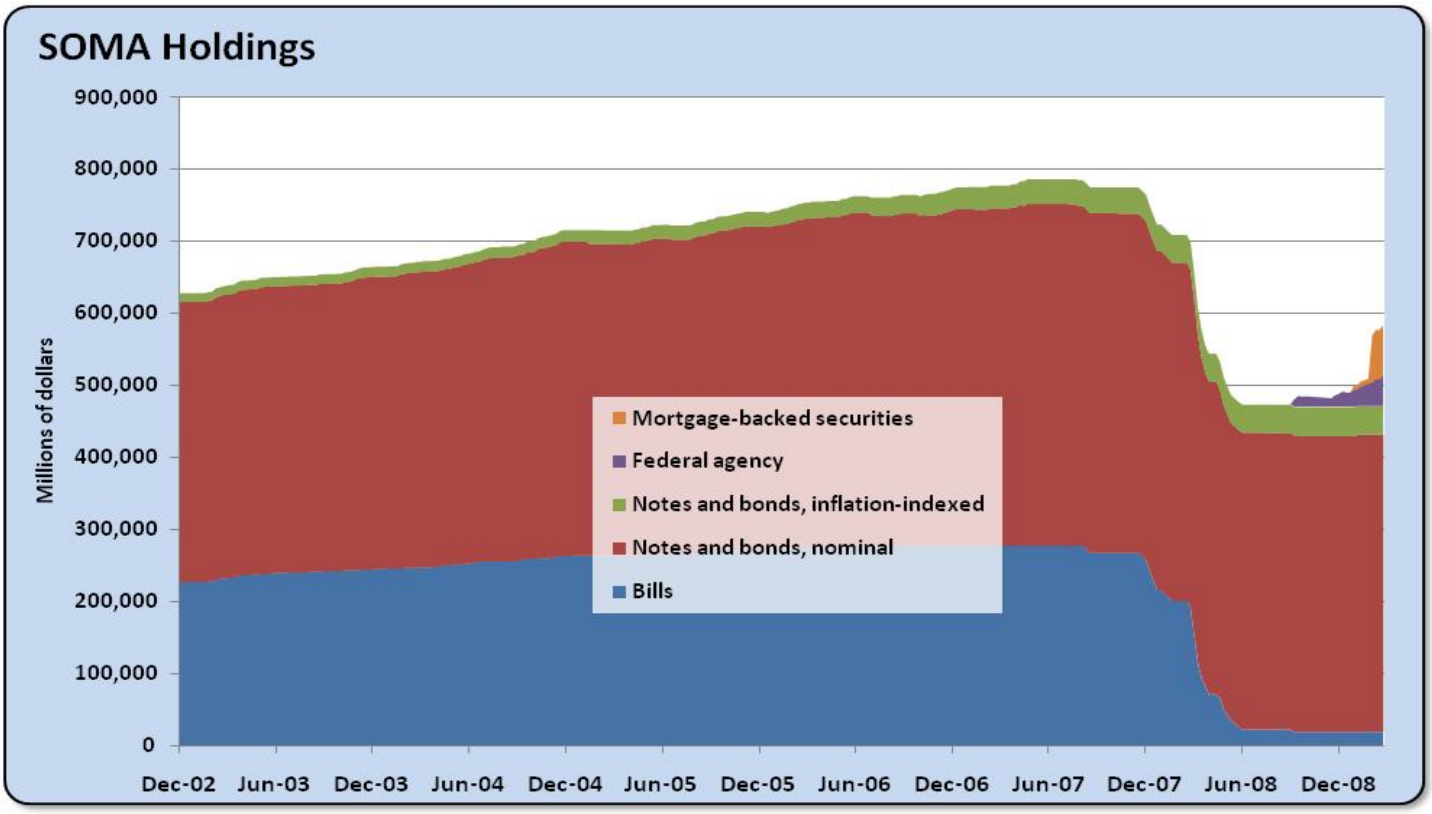
5. Collateral Held against Federal Reserve Notes: Federal Reserve Agents' Accounts

Millions of dollars

Federal Reserve notes and collateral	Wednesday Jan 3, 2007
Federal Reserve notes outstanding	958,508
Less: Notes held by F.R. Banks not subject to collateralization	177,161
Federal Reserve notes to be collateralized	**781,347**
Collateral held against Federal Reserve notes	781,347
Gold certificate account	11,037
Special drawing rights certificate account	2,200
U.S. Treasury securities	768,111

Back in January 2007, there were some $781 billion worth of Federal Reserve notes that required collateral (highlighted above) and the collateral provided was $11 billion in gold holdings (gold held by the U.S. Treasury), $2.2 billion on account primarily with the IMF, and $768 billion of Treasury securities (bills, notes, & bonds in the SOMA).

Looking back up to the SOMA Holdings table, as of January 3, 2007 there was $775 billion of Treasury securities held in the SOMA - an amount sufficient to collateralize the currency outstanding. However, as we move through the crisis response by the Federal Reserve, namely its credit easing policy, we see how the value of the SOMA decreased and its composition of assets changed (see Keeping it Clean for a detail discussion of **why these changes occurred**).



For comparative purposes, the following table shows the Collateral Held against Federal Reserve Notes for January 3, 2007 and March 11, 2009.

Collateral Held against Federal Reserve Notes

millions of dollars as of:	1/3/2007	% of Total	3/11/2009	% of Total	Change	% Change
Federal Reserve notes to be collaterized	781,347	100.0%	862,265	100.0%	80,918	10.4%
Collateral held against Federal Reserve notes						
Gold certificate account	11,037	1.4%	11,037	1.3%	-	0.0%
Special drawing rights certificate account	2,200	0.3%	2,200	0.3%	-	0.0%
U.S. Treasury securities	768,110	98.3%	304,638	35.3%	(463,472)	-60.3%
Agency debt	-	0.0%	44,432	5.2%	44,432	-
Mortgage-backed securities	-	0.0%	68,958	8.0%	68,958	-
Other assets pledged	-	0.0%	322,881	37.4%	322,881	-
Term securities lending facility	-	0.0%	108,120	12.5%	108,120	-
Total	781,347	100.0%	862,266	100.0%	80,919	10.4%

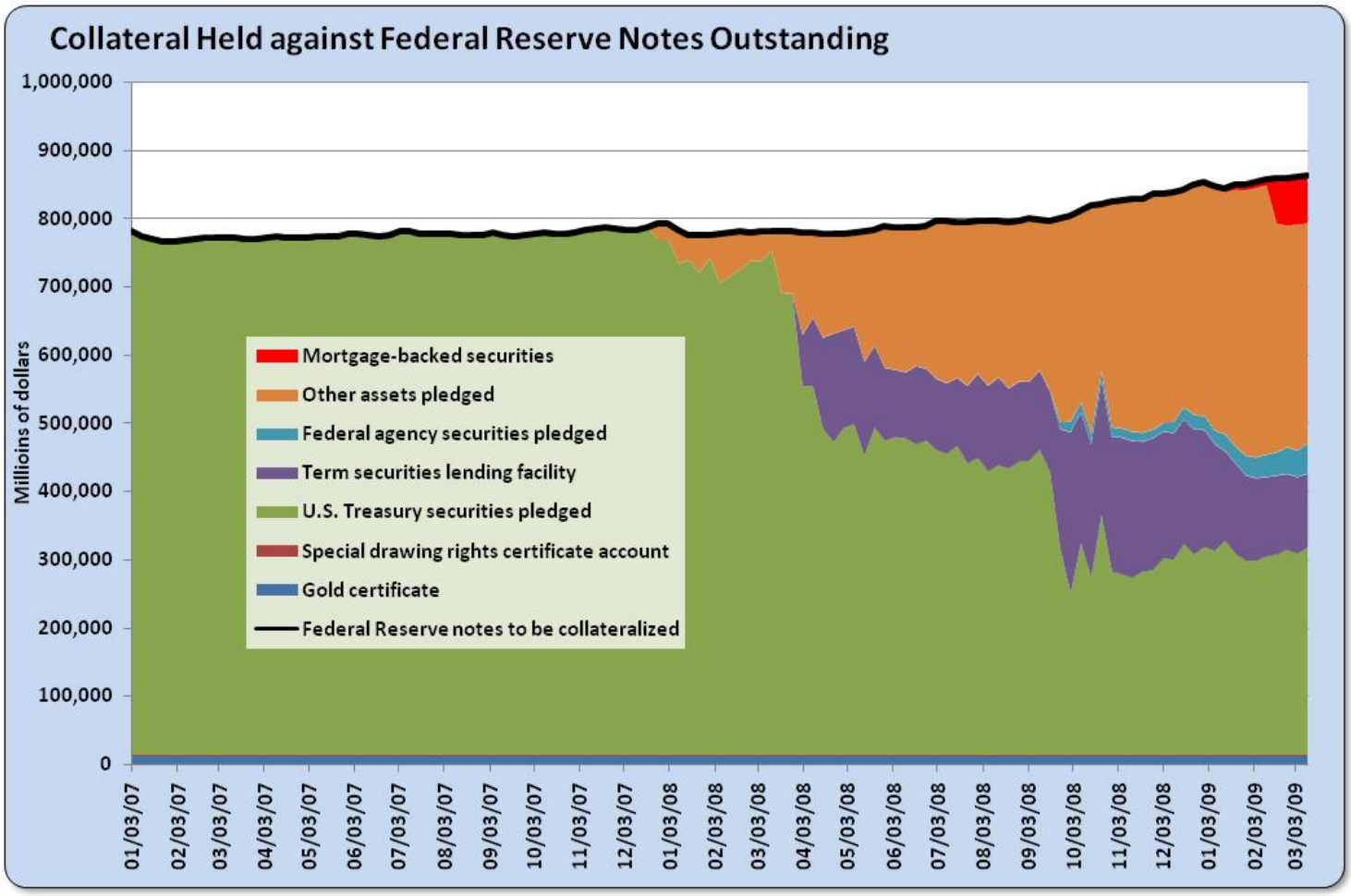
Note: Components may not sum to totals because of rounding
Source: Table 10 of Statistical Release H.4.1

As of March 11, 2009, there was $862 billion of Federal Reserve notes that required collateral but only $304.6 billion of U.S. Treasury securities available as collateral. To provide the remaining collateral, the Fed used the other SOMA assets (Agency debt and Mortgage-backed securities) and has pledged "other assets" for the balance.

Note: Under the "Term securities lending facility" (balance of $108 billion as 03/11/09), primary dealers may borrow high quality Treasury securities from the Federal Reserve. I advised the Fed that a footnote disclosure should be made to Table 10 indicating that the amount of U.S. Treasury securities shown as collateral actually includes securities lent to dealers. A copy of their response is attached.

The most obvious change in collateral is the "other assets pledged." Non-existent until December 2007, "other assets" now represent more than 37% of the collateral – a staggering $322.8 billion.

Notice the change in collateral as we move through the crisis. You can compare this chart to the SOMA Holdings chart above and the Factors Supply Reserve Credit chart near the beginning.



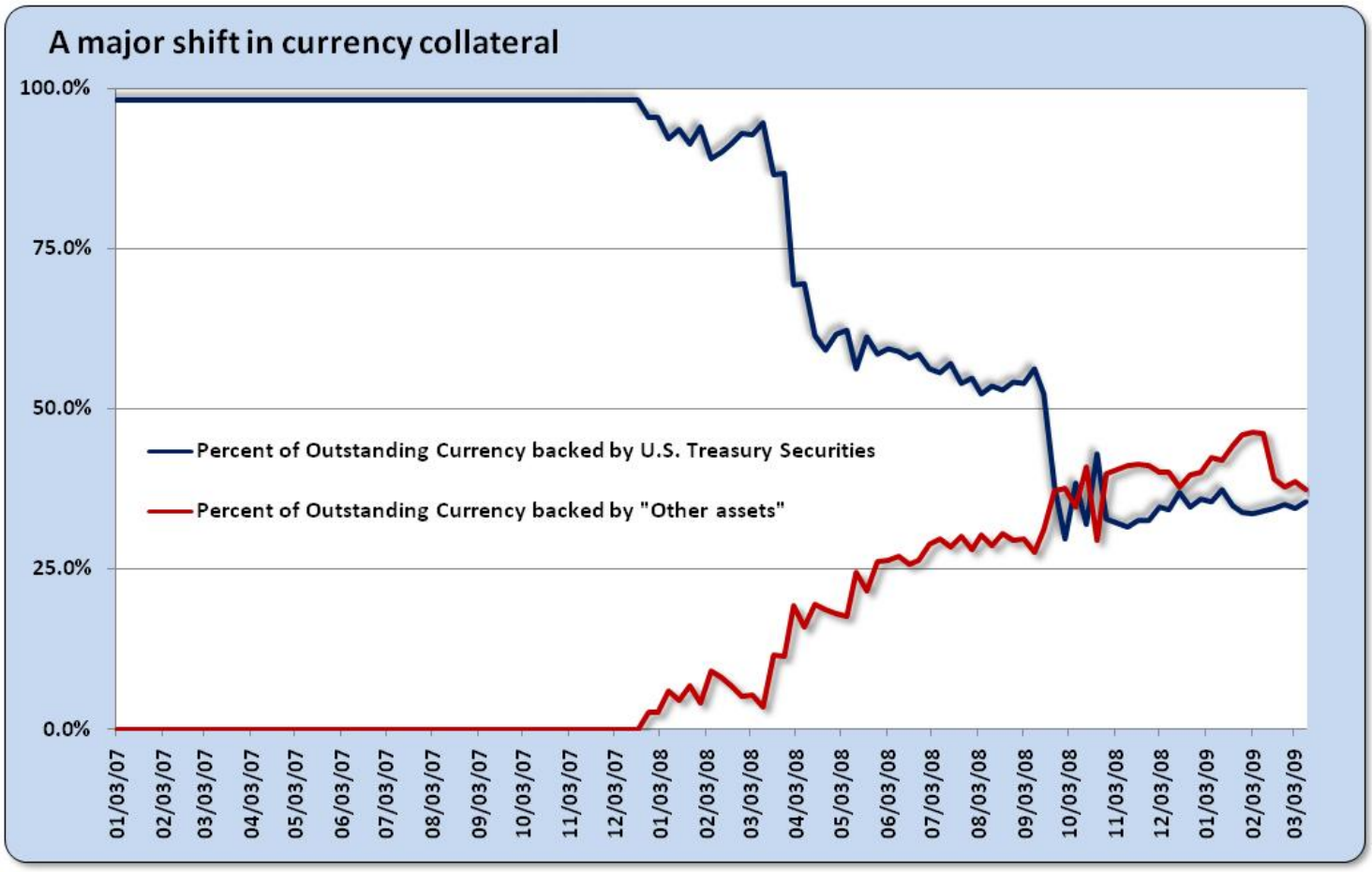
Looking back now you can see the consequence of the Fed's activity to buy and/or accept less than Treasury quality securities. This is the "side-effect" of the Fed's actions that has not been debated or even discussed.

Now, back to the "other assets pledge." As the Federal Reserve ran out of assets in the SOMA to provide as collateral for their outstanding notes, they pledged a group of "other assets" (which they are permitted to do) from their balance sheet. Finding this odd and not being content with such a description, I made a request under the Freedom of Information Act for a "detailed listing of the other assets pledged including a description and value." My request was made on December 18, 2008.

Having worked in accounting my entire professional career and most of that as an auditor, I had a feeling the "other assets pledged" was a "plug number" (an accounting term for a necessary number not necessarily accounted for). For example, Assets minus Liabilities equals Shareholder's Equity. Though you could "plug" the Shareholder's Equity number by simply subtracting the liabilities of a company from its assets, the fact is Shareholder's Equity consists of a number of quantifiable elements, i.e. Common Stock Outstanding, Additional Paid-in-capital, Retained Earnings less Dividends Paid, etc.

After numerous follow-ups and one letter from the Fed insisting on more time, I finally received a response to my request (which, for the record, was about one month late – but of course, they have been busy!) and as expected they describe the "other assets pledged" as a "catch-all line-item representing the difference in value between the total amount of currency in circulation that must be collateralized and the value of the specifically identified assets that could serve as collateral" – a copy of their response is attached.

From the above chart, the two things that immediately come to mind are 1) the decrease in Treasuries as collateral, and 2) the increase in "other asset pledged" as collateral. As a percent of overall collateral provided, the following charts the change in Treasury securities and "other assets pledged":



I fully appreciate the seriousness of the economic crisis we face as a nation and I grasp the gravity of what our government is trying to accomplish. However, I do believe the consequence of this "credit easing" should be debated in full and what I have described above **should be part of that debate**. We have embarked on a massive government experiment to solve a crisis that ultimately began with government manipulation in free markets (artificially low interest rates, excessive risk taking by Fannie May and Freddie Mac, modification of the Federal Reserve Act allowing the Fed to purchase less than Treasury quality securities, and many other actions). There must be accountability on the part of the Federal Reserve and the Congress that established it. The Federal Reserve notes we carry in our pockets, and have on deposit in our bank accounts, are legal tender debt instruments and must be accepted as payment. With such a fiat, it is incumbent upon our government to ensure these bills are properly collateralized with something of real value.

As it stands today, more than 60% of each dollar is now backed by a home mortgage, or auto loan, or a credit card balance, or the fixed assets of some corporation, or some combination thereof, instead of gold or Treasury securities.

Is it possible that all this can be undone when the crisis has passed? Certainly. But does that mean this is the right approach? Certainly not. Just because the Federal Reserve can be patient with non-performing assets, does not mean that they should purchase or lend against non-performing assets – this is simply the transfer of risk from a few to a taxpayer bailout by the many.

I realize this missive has moved far away from the typical "investor newsletter" and into the realm of politics and monetary policy…but sometimes we need to ask the hard questions, and this question of currency collateral needs to be asked.

I will leave you with two more graphics that no doubt will be called "inflammatory." They are based on the data as presented each week by the Federal Reserve – feel free to check it out yourself (last page of the report, Table 10).

https://www.federalreserve.gov/releases/h41/

If you have any questions, please feel free to let me know. If you have any comments, I would like to hear them. Like our other ecomments, this one will soon be posted online and please feel free to forward this around.

Best regards,
Roger

Collateral backing Federal Reserve Promissory Notes - U.S. Dollar

as of: **January 3, 2007**

Collateral backing Federal Reserve Promissory Notes - U.S. Dollar

as of: **March 11, 2009**