

The Bank at Mystic Seaport

By Rick Kilbride, Head of Fixed Income for Managed Accounts

A major custodian bank has become the mattress for the Street. It is taking institutional overnight deposits at a 0% interest rate. The deal is that the next day the institutions get their money back. Overnight, the cash is collateralized by some of the bank's Treasury holdings. There is brisk business. One institution is reported to have \$100 billion in that mattress.

This means that these monies are squirreled away and are not being invested in the credit markets or the economy. Lending into the credit markets – one week LIBOR is 4.25% at this writing – is being passed up for 0% and the comfort of the return of capital rather than any worry about the return on capital. This behavior has historical precedent.

At the reconstructed seaport village in Mystic, Connecticut, there is a circa-1850 bank. This small stone fortress has an inner vault of stone and steel. Though this was the same era as Jesse James, whose operations were centered elsewhere, the real fear of the day was fire. The granite vault was the most fireproof place in a mid-19th century town. Ship owners and merchants deposited their cash in that vault and paid a fee for the privilege of having their valuables kept secure. In today's world, we are pretty much back to that.

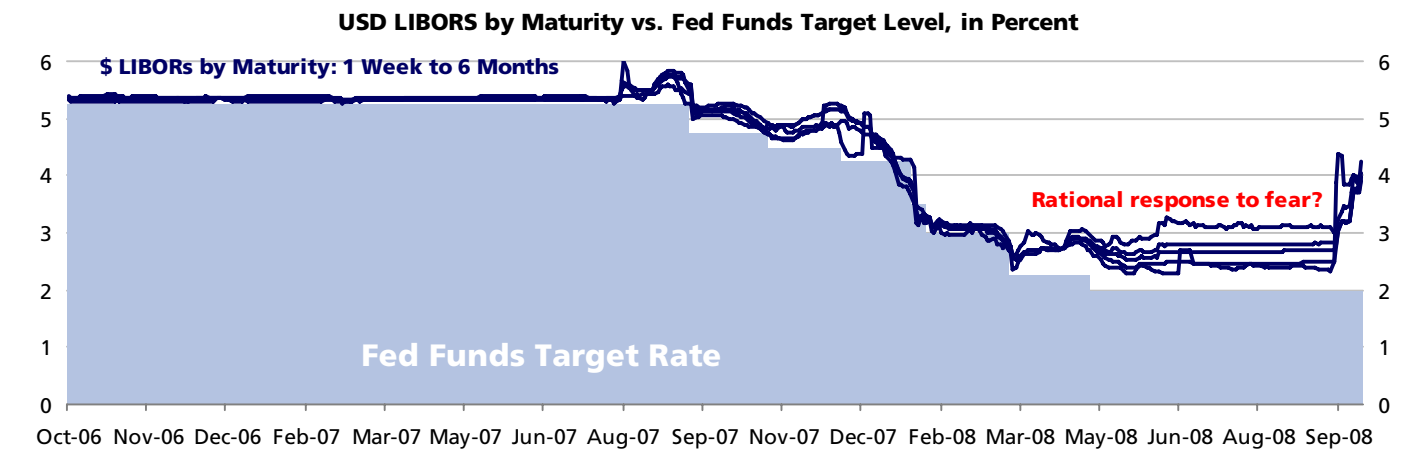
The desire to remain safe and liquid is driven by real fears toward money market funds, some of which have lost value, and caution toward bank deposits, when several banks have

failed. The unwinding and rescue of numerous banks shows that almost any of them are vulnerable. Investors don't want to get caught in that fire. At the same time, many companies have drawn on their credit lines at banks so that they have cash, just in case they need it. The fear is that access to the lines could be cut off if banks, strapped for capital and increasingly buried in losses, restrict credit lending further.

While preserving cash and capital is a rational response to fear, it does make for a world that looks a lot like the environment in which Mystic Bank operated. Because the funds were held safe in the vault, they were not loaned out. Indeed, it was associations of business people, the owners of shares in the whaling ships, that provided credit. The banks didn't have the funds or the risk tolerance to do that.

In recent days we have seen a major restructuring of Wall Street and the banking community. Fannie, Freddie, AIG, Lehman, Merrill, WaMu, and Wachovia are transformed, through a variety of different mechanisms. Goldman Sachs and Morgan Stanley are struggling ships making way toward a new future as deposit taking institutions. Populist instincts – that Wall Street problems don't impact Main Street – are oblivious to economic reality. In the words of R E M, "everybody hurts." Sourcing credit on Main Street may require new associations to be built if banks prove that they aren't up to it. With this uncertain playing field, it is likely that "it's the end of the world as we know it." And, personally, I don't feel fine. ■

Restoring Inter-Bank Lending (which is Decidedly Illiquid) is Critical to Functioning Credit Markets



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