

America must keep consumer liquidity flowing

By MEREDITH WHITNEY

As an analyst, it is my job to do fundamental research and call it as I see it, and my bailiwick is financials. My outlook has been negative for over a year and, technically, I have been “right” on my calls. Seeing massive capital destruction has brought me no pleasure, but unfortunately I see little on the horizon that would change my outlook. In fact, after observing the US economy so derailed, I feel that I must act as a citizen of this great country to attempt to offer solutions to this economic train wreck we are all involved in.

First, I am more bearish today than I have been in the past 18 months. In so far as the market has impacted on the economy, capital destruction has been so intense that multi-trillions in capital raised by institutions through both private and public capital has gone to plug holes and not stabilise the effects of shrinking liquidity to corporations and consumers. More than \$3,000bn (€2,365bn, £1,955bn) of available credit has been expunged from the markets and therefore corporate and consumer borrowers so far this year.

I estimate that the mortgage market will shrink for the first time in US history and that the credit card market will be 18 months behind it. While just over 70 per cent of US households have access to credit cards, 90 per cent of these people use credit cards as a cash-flow management vehicle, or revolve payments at least once a year. While the credit card market is small relative to the mortgage market, it has grown to play a key role in consumer liquidity. Declining liquidity here will have disastrous effects on consumer spending and the economy. My primary concern is preserving liquidity to consumers, who command more than two-thirds of gross domestic product.

There is no doubt that time will be the greatest healer, but there is a strong argument for putting the financial system through a methadone-clinic-style rehabilitation as opposed to the “cold sweats” rehab that we face. The US government appears to feel the same, which is why various versions of direct government lending and quasi- as well as real bail-outs have been announced. Certainly, credit was extended to unworthy borrowers, but the baby is now being thrown out with the bath water. I expect more broad-based credit contractions but, specifically, more than \$2,000bn in credit lines to be cut in reaction to risk aversion, constrained capital and regulatory change.

Here are some easily adoptable changes that would make a difference.

First, re-regionalise lending. Since the early 1990s, key bank products, mortgages and credit card lending were rapidly consolidated nationally. Banking went from “knowing your customer” or local lending, to relying on what have proven to be unreliable FICO

credit scores and centralised underwriting. The government should now motivate local lenders (many of which have clean balance sheets) to re-widen their product offering to include credit cards and encourage the mega banks to provide servicing and processing facilities to banks that sold off these capabilities years ago.

Second, expand the Federal Deposit Insurance Corporation's guarantee for bank debt. Banks need to know they can access reasonably priced credit for an extended period to continue to extend new credit lines. Any semi-conscious bank management team knows that capital and liquidity are precious and therefore is hoarding both.

Third, delay the introduction of accounting rule FAS 140 until 2011 or 2012. These moves to bring off-balance-sheet assets back on balance sheet for the sake of transparency are a mirage. The primary assets that will come back on to balance sheets are credit card loans. Frankly, there is more transparency in off-balance-sheet master trust data than in on-balance-sheet accrual accounting. Banks cannot afford it now and it will further constrain credit.

Fourth, amend the proposal on Unfair and Deceptive Lending Practices that is set to be adopted in 2010. The proposal includes one major change that will lead to a severe unintended consequence – pulling credit from consumers. Restricting lenders' ability to reprice an unsecured loan will cause them to stop lending or to lend less. This change could cut over \$2,000bn in unused credit card lines, or over 40 per cent of unused credit lines. With so many Americans relying on their credit cards as a major source of liquidity, it would be equivalent to a major pay cut.

This is no time for partisanship. The situation is too dire. These changes are ones I would never have imagined endorsing a year ago, but these are extraordinary times.

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