Fed Bends Rules To Help Two Big Banks

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If the Federal Reserve is waiving a fundamental principle in banking regulation, the credit crunch must still be sapping the strength of America's biggest banks. Fortune's Peter Eavis documents an unusual Fed move.

By Peter Eavis, Fortune writer

NEW YORK (Fortune) — In a clear sign that the credit crunch is still affecting the nation's largest financial institutions, the Federal Reserve agreed this week to bend key banking regulations to help out Citigroup

(Charts, Fortune 500) and Bank of America (Charts, Fortune 500), according to documents posted Friday on the Fed's web site.

The Aug. 20 letters from the Fed to Citigroup and Bank of America state that the Fed, which regulates large parts of the U.S. financial system, has agreed to exempt both banks from rules that effectively limit the amount of lending that their federally-insured banks can do with their brokerage

affiliates. The exemption, which is temporary, means, for example, that Citigroup's Citibank entity can substantially increase funding to Citigroup Global Markets, its brokerage subsidiary. Citigroup and Bank of America requested the exemptions, according to the letters, to provide liquidity to those holding mortgage loans, mortgage-backed securities, and other securities.

This unusual move by the Fed shows that the largest Wall Street firms are continuing to have problems funding operations during the current market difficulties, according to banking industry skeptics. The Fed's move appears to support the view that even the biggest brokerages have been caught off guard by the credit crunch and don't have financing to deal with the resulting dislocation in the markets. The opposing, less negative view is that the Fed has taken this step merely to increase the speed with which the funds recently borrowed at the Fed's discount window can flow through to the bond markets, where the mortgage mess has caused a drying up of liquidity.

On Wednesday, Citibank and Bank of America said that they and two other banks accessed $500 million in 30-day financing at the discount window. A Citigroup spokesperson declined to comment. Bank of America dismissed the notion that Banc of America Securities is not well positioned to fund operations without help from the federally insured bank. "This is just a technicality to allow us to use our regular channels of business with funds from the Fed's discount window," says Bob Stickler, spokesperson for Bank of America. "We have no current plans to use the discount window beyond the $500 million announced earlier this week."

There is a good chance that other large banks, like J.P. Morgan (Charts, Fortune 500), have been granted similar exemptions. The Federal Reserve and J.P. Morgan didn't immediately comment.

The regulations in question effectively limit a bank's funding exposure to an affiliate to 10% of the bank's capital. But the Fed has allowed Citibank and Bank of America to blow through that level. Citigroup and Bank of America are able to lend up to $25 billion apiece under this exemption, according to the Fed. If Citibank used the full amount, "that represents about 30% of Citibank's total regulatory capital, which is no small exemption," says Charlie Peabody, banks analyst at Portales Partners.

The Fed says that it made the exemption in the public interest, because it allows Citibank to get liquidity to the brokerage in "the most rapid and cost-effective manner possible."

So, how serious is this rule-bending? Very. One of the central tenets of banking regulation is that banks with federally insured deposits should never be over-exposed to brokerage subsidiaries; indeed, for decades financial institutions were legally required to keep the two units completely separate. This move by the Fed eats away at the principle.

Sure, the temporary nature of the move makes it look slightly less serious, but the Fed didn't give a date in the letter for when this exemption will end. In addition, the sheer size of the potential lending capacity at Citigroup and Bank of America – $25 billion each – is a cause for unease. Indeed, this move to exempt Citigroup casts a whole new light on the discount window borrowing that was revealed earlier this week. At the time, the gloss put on the discount window advances was that they were orderly and almost symbolic in nature. But if that were the case, why the need to use these exemptions to rush the funds to the brokerages?

Expect the discount window borrowings to become a key part of the Fed's recovery strategy for the financial system. The Fed's exemption will almost certainly force its regulatory arm to sharpen its oversight of banks' balance sheets, which means banks will almost certainly have to mark down asset values to appropriate levels a lot faster now. That's because there is no way that the Fed is going to allow easier funding to lead to a further propping up of asset prices.

Don't forget: The Federal Reserve is in crisis management at the moment. However, it doesn't want to show any signs of panic. That means no rushed cuts in interest rates. It also means that it wants banks to quickly take the big charges that will inevitably come from holding toxic debt securities. And it will do all it can behind the scenes to work with the banks to help them get through this upheaval. But waiving one of the most important banking regulations can only add nervousness to the market. And that's what the Fed did Monday in these disturbing letters to the nation's two largest banks.

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