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Is the world going to ELE?

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In order to ease my four Advil headache, my son forced me to sit down and watch a DVD with him. As destiny would have it, the movie was "Deep Impact." For those of you who have not seen it, make sure that you do not. However, an important character twisted and wrangled her way into my brain: "ELE." She was particularly interesting since I had heard her name bandied about on trading floors for the last couple of weeks. I had thought her to be a fictitious superheroine – 6 feet tall, Harvard JD-MBA, nuclear physicist, cum laude graduate from MIT, who was the financial world's counterpart to Jack Bauer. In fact, in real life she is even more imposing. "ELE" stands for "Extinction Level Event."

Has the Current Bank Bailout Program Salvaged the Banking Sector?

I would like to make it perfectly clear that I have absolutely no idea how the intricacies of the global financial system function. I had previously taken solace in believing that "the other guys" did understand. What we all now realize is that nobody understands and nobody ever understood. We have also come to realize that the current turmoil is larger, more complicated, more volatile, more interconnected and more global than anyone had anticipated.

It appears that this past weekend the governments of the world tried to remedy their knee-jerk reactions and adopted a comprehensive nationalization and support plan for the world's banking systems. **All capitalists hate socialism until they really need it.** For the moment, this plan has quelled the panic and added support to the solvency of the banks. When coupled with a short-lived 900 point rise in the Dow, many are hoping that we have turned the corner for the clubhouse.

One of the looming questions will be "is this bailout and capital infusion enough in light of the impending remaining problems in the financial system?"

The irony of our government's recent acts is that we went from "not too big to fail" (Lehman, Bear and WaMu) to "no one will fail." One of the lessons learned is that it is better to fail later. In retrospect, what a tremendous dose of bad luck for the shareholders and employees of those institutions that were allowed to fail and what tremendously bad judgment by the handful of government agencies that delayed implementing the inevitable rescue plan and applying it equally to all institutions. Is it any wonder that only the Japanese could be enticed by Paulson's guarantees to invest in Morgan Stanley? Assurances to some and the death sentence to others. Somewhat confusing to say the least!

This response to our own financial crisis seems dramatic and startling. In actuality, it is long overdue and is not a result of any creative thought. It is certainly a socialistic cure, however, one that was needed at this point in the crisis. The absurdity of the situation is that it took us so long to get here. The IMF has analyzed banking crises around the world and their position could be summarized in 10 simple steps to follow in such a crisis. Why we didn't read the manual one year ago is a wonder. Please take the time to read the IMF's 10 recommended steps below:

Steps 1–4. The acute crisis phase: measures to stop the panic and stabilize the system.

1. The crisis usually begins because, in one form or another, there is excessive leverage in the economy. In the early stages there may also be a degree of denial on the part of the banks and the government.

2. Bank runs by creditors and depositors start and intensify. The central bank responds by providing liquidity support to the affected banks.

3. When central bank liquidity is unable to stop the runs, the government announces a blanket guarantee for depositors and creditors. Such a measure is intended to reduce uncertainty and to allow time for the government to begin an orderly restructuring process.
4. All along, the central bank tries to sterilize its liquidity support to avoid a loss of monetary control.

Steps 5–8. The stabilization phase: measures to restructure the system.

5. The authorities design the tools needed for a comprehensive restructuring, including the required legal, financial, and institutional framework.
6. **Losses in individual institutions are recognized. The authorities shift the focus from liquidity support to solvency support.**
7. The authorities design a financial sector restructuring strategy, based on a vision for the post crisis structure of the sector.
8. Viable banks are recapitalized, **bad assets are dealt with, and prudential supervision and regulations are tightened.**

Steps 9–10. The recovery phase: measures to normalize the system.

9. Nationalized banks are reprivatized, corporate debt is restructured, and bad assets are sold.
10. The blanket guarantee is revoked, which, if properly handled, is a non-event because the banking system has been recapitalized and is healthy again.

Bad Banks

Unfortunately, it appears that the government has failed to properly implement one critical step: the "bad bank!"

We have personally been involved in three bank restructurings: American Savings Bank during our Robert Bass Group tenure, Korea First Bank in which we partnered with David Bonderman (the best and the brightest investor in the world) and Richard Blum, and Aozora Bank with Softbank and Cerberus. The lesson learned was that the administration of the bad bank, the pricing of those pre-existing bad assets, and the process for discovering and pricing new bad assets was critically important to the success of the good bank but fraught with inter-governmental conflicts.

There are five primary Federal agencies monitoring US banks:

1. Federal Reserve Bank
2. Securities & Exchange Commission (SEC)
3. Federal Deposit Insurance Corporation (FDIC)
4. Office of Thrift Supervision (OTS)
5. Office of the Comptroller of the Currency (OCC)

None of them agree on anything and they all have various missions and directives. Most bank nationalizations transpire simultaneously or after the initiation of a bad bank. This makes the argument over valuation easier since the existing shareholders have already submitted. Pricing under the new plan will be more contentious. The market must be anticipating that the banks will just sell bad assets to the remaining funding in "TARP." The "held to maturity" pricing in TARP is above market and the amount of funding available in TARP will be far short of the amount needed to house all of the toxic assets. The MBS assets are merely the first harvest, and behind it are leveraged loans, CMBS, CDS, credit cards, and high-yield debt. The amount needed to acquire these assets, even at true market value, could be in the trillions.

The government will no doubt still find it necessary to create a super bad bank. No matter what the monetary injection into the system, bad assets need to be culled. The management of good banks and bad banks have different incentives. A lingering hold on bad assets can produce a Japanese-style result and a protracted recovery.

The crippling issues of regulatory capital compliance, net worth, and RAP accounting will be immensely difficult to deal with after the fact of capital infusion. The government has taken the position that it will not assert control through the Board. In fact, there is no need. It will control the balance sheet and the company through its regulatory powers and the existing shareholders will be subject to the rule of the regulatory law. What they give with one hand they can take away with the other. Without forbearance agreements, even with the new capital, most of the nine banks would be insolvent with just a few more problems.

The conflicts which will be presented to the government without a corresponding bad bank structure will be monumental. The assets inside of the banking box are still toxic. Pricing has not become easier and buyers will be fewer. The decisions made by the banks must be to maximize value for the shareholders. However, the government who is a preferred shareholder will have different pricing thresholds and desires than the old common shareholders. We do not know yet where the toxicity is. It is endemic. The future defaults of leveraged loans, high-yield loans, CMBS, etc., are yet unfelt. These technical definitions of compliance and forbearance will be critical and having a bad bank structure to digest and redistribute is critical.

Just in time – Recession

The next issue which needs to be addressed is whether the banks commence relending, and if so, to whom, on what and what do they do with the debt? This will all become clear over time.

In the meantime, however, the economy itself is undergoing a serious correction.

Certainly the financial meltdown has drifted into the face of a brewing recession, and although the "little guy" did not understand the financial meltdown dilemma, he is feeling the pinch of an ever-tightening economy.

- Diminution of corporate earnings – 4Q08 and 2009 corporate earnings will be far below telegraphed expectations. Capital expenditures will decrease and layoffs will increase.
- Unemployment is a tough number to understand, but it is not tough to understand the people around us. Almost 15% of America's workforce is paid on one form of commission or another. From the Avon lady to the Morgan Stanley broker, huge numbers of people rely on selling stuff in order to eat. When sales drop, so drops their food intake. As you can imagine, this trickle down causes waves of discomfort throughout the food chain. Expenses are curtailed, lifestyles modified, vacations cancelled, maids and nannies fired, rent payments late and new cars not an option.
- The result of this downturn will be felt dramatically in commercial real estate of all kinds followed by the CMBS debt which has financed them, followed by the commercial loans which the community and regional banks financed. Simultaneously, the credit card explosion will progress and the bath tub will be filling with the dizzying billions of SIV assets and CLO funds being dumped on a "make any bid" basis.
- When importers and exporters of products can not obtain a letter of credit to utilize for the purchase of their goods, the food chain gets slammed. Ships, docks, longshoremen, truckers, teamsters, warehouses, and retailers all feel the dramatic effect.
- The 11,000 homeowners a day who are being foreclosed upon are not cheering on the sidelines for the new Fed plans or the surge in the stock market. The average American believes that all of this juggling only benefits the "fat cats," the guys who caused the mess in the first place.

They feel and see very little relief in sight for themselves. All the foreclosures are only a small percent of total homeowners (just over 2%) but their neighbors are all watching and starting to adapt their behavior -- consuming less, borrowing less, worrying more and perhaps earning less as businesses across the nation tighten their belts and growth slows.

Lessons of Capitalism to Socialism and Back

Our memory for pain is always overcome by our innate instinct for gain. As in any life-threatening situation, at the moment of trauma we all vow to change our errant ways and that if given one more chance we will clean up our acts. This is the constant mantra in the short term trauma, it gets a bit weaker in the midterm and in the long term it is a race to the return of our errant ways.

This mess will clean itself up sooner or later and "panic" will once again morph to "complacency." What lessons will have been learned? What will change?

Our American Capitalist system will no doubt be viewed by the world as having failed. In fact, the salvation was almost a socialistic triumph.

"Never a borrower nor a lender be." So how did borrowing become such a way of life and how did those who lend gain such prominence and acceptability in our society? Our prestige and stature in the world as a financial leader and fighter for capitalism is on the rocks, to say the least. We don't have many friends in the world rooting for our system to succeed.

Will this recent near-death experience quell our thirst for debt and will bankers and lenders be emboldened or chastened? Will entrepreneurs re-spring to run circles around the heavily-regulated banking industry and renew America's star around the world? The answer is "definitely." The issue is "when." The problem is that our entrepreneurial spirit has been dampened by debt and until we get through **debt rehab** we can't really start to delever our business or our personal lives. We need the banks to open up the spigots soon.

The thirst for refinancing is unquenchable: corporate refinancings alone are about $150 billion per quarter, LBOs, CMBS, high-yield debt, CDS liabilities and liquidity for undistributed pipeline loans.

Who's at Fault? We All Are.

We all took our eye off the ball through this indulgence. We outsourced jobs and technology to third world countries which could produce goods less expensively because producing the goods ourselves was deemed too much work for too little gain.

The American spirit of capitalist stewardship and drive was overcome by the lure of Easy Street. We could acquire wealth beyond our dreams with far less sweat and very little equity. We believed that the leverage door swung only one way. Unfortunately, the far reaching corners of this debt dilemma have not yet been mapped and the current bailout plan will need to allocate much more money and resources along with a well-run "RTC-2" in order to be successful.

Rather than selling goods and services, we as a nation created a substantial amount of our GDP from selling loans and financial products - Financial Alchemy.

Liquidity and "Originate and Syndicate"

The repeal of Glass-Steagall started the slippery slope.

The sale of loans became big business:

- Fees could be charged for origination and spreads made in the sale.
- Liquidity had a huge premium and the fact that there was a market-maker who would trade the paper and offer a quick exit was tremendously desirable.
    - > This was the beginning of the big problem.

> Loans had been held on the balance sheets of banks and not transferred or sold. It was asset-liability matching. The repeal of Glass-Steagall changed it all in 1999, when it became an encouraged practice to securitize illiquid loans.
>
> Sellers bred a new group of buyers who were not interested or concerned with the underlying collateral, but instead were relying upon a market-maker. When the market-maker did not show up, no one knew how to value the assets.

Competitiveness and Conservatism

The efficient market is still signaling that it will take no risk when it comes to credit. Consequently, it will still be quite difficult to find many of the counterparts of risk necessary to flush the clogged financial pipelines. Further writedowns and blow ups will surely occur and they will occur in a descending economy. The stock market will no doubt have further and dramatic dips.

Along the road of figuring out true counterparty risk, as always, we will hit some Intervening Unexpected Event, which will change it all. However, the search for counterparty risk will continue to be taxing. The Lehman CDSs were settled last week, however, payments are not due until Oct 21. The sums trading hands are around $250 billion. This is one credit, one firm. There is $62 trillion worth of these **nuclear warheads** in existence. Finding the counterparties and collecting will be an interesting task.

Why the Banks Have Most Likely Not Hit Bottom

- Corporate earnings from most sectors will be weak and capex programs will be slashed.
- Hedge funds will continue to be tortured by redemptions and their interplay with banks was incestuous.
- The effect of hedge funds pulling out of the market will chill many sources of corporate finance – Redemptions are massive.
- Counterparty risk in the CDS market will remain a bit of a mystery.
  - > CDS was equally as bad at the plate as equity and debt players
  - > The governments infusion of equity collapsed the CDS spreads
- CDS payments and failures at levels that are unfathomable – watch Lehman reconciliations on Tuesday, Oct. 21st.
- The housing market will remain anemic.
- Insurance companies, automakers, airlines and shippers are all in trouble.
- State and municipalities are also Fed borrowers.
- Corporate refinancings at $150 billion a quarter with no one to refinance.
- Massive margin calls on the titans of America which will cause collapse in the corporate equities they own.
- Forced liquidations.
- LBO restructurings and covenant violations.
- No DIP financing for bankruptcies, only liquidations.

Long-term Consequences

The good news is that all we care about at the moment is SURVIVAL. We need to fight every day to monitor and steward the best deals we can find -- the ones we own. However, eventually we will need to examine the long-term effects of our triage.

- Huge inflationary pressures. Inevitable higher interest rates and taxes.

- Massive national debt and budget deficits.
- Are we deferring the pain like Japan did?
- $11.3 trillion national debt is really $55 trillion due to OBL (off balance-sheet liabilities).
- Implications of investment losses for pension funds and endowments?

Bottom Line

The game is afoot and not over. Don’t panic and don’t be euphoric. The discoveries will be constant and unsettling. Fortunately, the world powers have committed to win it. Now we all have to figure out what exactly that means.

Based upon our past experience at implementing bank takeovers and "distressed asset" management and dispositions, we suggest that we all buckle our seatbelts for a longer ride with lots of ups and downs before we arrive to safety. Fortunately, it looks like ELE will not be in the passenger seat.