

## Now What?

### *Looking Back*

Last year it became apparent that the balance sheets of major financial institutions were suspect. With the decline in the housing market and a deepening recession, the viability of structured securities held by most of the largest banks, insurance companies and investment banks was called into question, and with it, the liquidity and solvency of the very institutions that held and/or insured such securities. The prior administration in Washington assured that the key to solving the problem was to remove the troubled securities from the balance sheets of the institutions. They would be purchased by the government “at a discoverable fair market value.” Equity investors were concerned that if they were purchased below financial statement carrying value, the solvency issue would be exacerbated. If purchased at or above book value, the “taxpayers” would be overpaying. And of course, book value was clearly in excess of then realizable market value since there were no purchasers willing to invest in such securities. Presumably, however, once the balance sheets were clean, fresh equity capital could be attracted by the banks.

Until the troubled asset-backed securities were removed from the balance sheets, they would be “marked-to-market” to reflect the decline in realizable value or marked to best estimate (marked-to-model) of realizable net present value of cash flows. Since not all assets (not even the majority) held by the banks were securities subject to the mark-to-market rules, it caused investors to consider whether loan-loss provisions and other asset impairment valuation reserves were adequate for the assets not held for trading or as available for sale.

### *Fast forward*

Recently, the new administration announced its plan to purchase the troubled assets in private-government partnerships. The plan is designed to address two classes of assets held by the banks—portfolio loans and asset-backed securities. The asset-backed securities include residential and commercial mortgage-backed securities and other asset-backed securities including packaged consumer loans and perhaps credit card receivables.

To effect the purchase of portfolio loans an entity would be created in which the government would invest TARP funds alongside a private investor group. These investments would be the equity portion of the entity’s capital structure. It appears that the capital would be invested on a *pari passu* basis. The entity would then issue debt that would be guaranteed by the FDIC. Because this guarantee is treated as a direct obligation of the FDIC, it carries the full faith and credit of the U.S. government. The result of this structure is that the private investor will bear 7% of the risk in exchange for 50% of any gain realized.

A similar but less leveraged approach is employed to address asset-backed securities. A partnership will be created to purchase these securities. A private investor will invest equity capital in the entity, and the Federal Reserve through the TALF program will co-invest on a dollar-for-dollar basis, apparently *pari passu*. The Treasury will then make a loan to the partnership that will range from 50 to 100% of total equity capital. As a result, the total leverage in the partnership as a percentage of capital structure will range between 33 1/3% and 50%.

Because the private investors will invest a greater percentage of risk capital in the asset-backed securities program there will be a stronger incentive to drive a hard bargain on price as compared to the loan portfolio purchase transaction where the relatively small amount of capital placed at risk by the private investor is more akin to the cost of an option on the underlying assets.

There remains considerable uncertainty with respect to these programs. In the portfolio loan program the FDIC will conduct auctions for pools of loans. It is the hope that such auctions wrapped with attractive financing will facilitate price discovery. The question remains, however, as to whether these auctions will yield a price that is in excess of book value. That is, if the banks have not appropriately provided for loan-loss reserves, upon sale there would be additional write-offs experienced by the banks. Simply put, book value may be thought of by private investors as merely the asking price from which to begin. As to the asset-backed securities, the information thus far released does not refer to an auction process. It is likely, therefore, that these transactions will be separately negotiated between buyer and seller and it is not clear that pricing expectations of the respective parties are such that there can be confidence that a deal will be struck. The same concern with regard to financial statement carrying value also applies to these securities.

#### *In the meantime*

- Hundreds of billions of dollars have been invested by the government in major financial institutions.
- The FDIC has seized 45 banks in the past fifteen months and Lehman Brothers, Bear Stearns, and Merrill Lynch have imploded.
- Hundreds of billions of dollars of troubled securities have been guaranteed by the government.
- The government has provided bailout funds to the auto industry (and recently announced a program to assist auto industry suppliers).
- The government has taken control of Fannie Mae and Freddie Mac, their shareholders forfeiting their interests though bondholders have thus far been protected.
- The Federal Reserve is supporting the commercial paper markets – standing ready to purchase from issuers and money market funds.
- The FDIC has lent its credit to newly issued debt of financial institutions.
- And, the government injected massive amounts of capital into AIG to avoid systemic risk attributable to the potential failure of AIG to pay counter-parties on credit default swap agreements.

Of course, there are still many works in process:

- The administration's economic stimulus plan calls for approximately \$800 billion of tax cuts and government spending on state benefits, infrastructure, and other near and intermediate term projects in an effort to save or create jobs.
- The Federal Reserve TALF program has been launched to finance the purchase of newly originated asset-backed securities in an effort to create liquidity in the securitized credit markets by creating avenues for leveraging capital, thereby encouraging lending to consumers and making credit more available. Fannie Mae and Freddie Mac have also increased the dollar threshold for qualifying loans.
- The Federal Reserve began to commit in excess of \$1 trillion to purchase Treasury bonds and mortgage-backed securities insured by Fannie Mae and Freddie Mac. (This expansion of the Fed's balance sheet is often referred to as "printing money".) The credit markets immediately responded with lower interest rates. The goal of the Federal Reserve is to nudge private capital to seek higher returns in other investments, lower mortgage rates, and stem the decline of housing prices.

Finally, it appears that the amount of FDIC guarantees required in the loan portfolio program will require Congressional action to raise FDIC borrowing/guarantee limits.

### *At the same time*

Outrage over compensation levels at institutions receiving government bailout funds has dominated discussions in the media and halls of Congress. Also in the headlines – the concept that mark-to-market accounting standards should be relaxed for regulatory capital purposes was floated and gained traction as bank CEOs embraced the idea and Congress held hearings to explore it and consider extending it to financial statements, as well. The FASB is working on it and is scheduled to vote on April 2<sup>nd</sup>.

The equity markets have reacted to all of this uncertainty, rallying on the hope surrounding government announcements and news of possible relaxation of the mark-to-market rules, and selling off on news of increased unemployment, deepening recession, declining home prices and declining corporate earnings. (We also note that company share buybacks have significantly declined, no longer contributing to earnings per share growth.) During the first quarter of 2009 the S&P 500 declined approximately (11.01%); the Dow Jones Industrial Average declined approximately (12.48%). The Russell 1000 and Wilshire 5000 indices produced losses of approximately (10.46%) and (10.56)%, respectively. The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index lost approximately (14.95%) and (8.66%), respectively. These losses were steeper but trimmed as equity markets rallied in March.

### *Looking Ahead*

#### *Observations and concerns*

We concur with President Obama that the unwinding of this economic crisis will take time. It takes time for debt levels to decline as a result of pay downs and restructuring. It takes time for demand and supply forces to reach an equilibrium point that will support asset values. With consumers at record debt levels and with housing prices declining, it is improbable that consumer spending can lead the way to near term recovery. With the economy in severe recession and unemployment climbing, corporations are anticipating continued reduction in demand and have accordingly reduced workforce and technology and other growth oriented spending. The banking system remains under pressure from the illiquid assets clogging balance sheets and the inability to sell loans into the securitization market. The seizing of the securitized loan finance channel has greatly and conclusively reduced the availability of credit which, in turn, further slows the economy.

We do not believe that we are witnessing merely the ebb and flow of the economy. Rather, we are experiencing the result of an enormous bubble in real estate prices that was funded with high-risk lending, secured by insufficient collateral, to borrowers that were not credit-worthy. Unfortunately, the severity of the downturn, that resulted when the bubble burst has also pressured the values for loans that when originally made were to credit-worthy borrowers with sufficient collateral value. We are also experiencing the effects of sustained mis-pricing of risk in consumer and corporate credit markets and its impact on the equity markets.

We believe that the catalyst for the resumption of economic growth cannot only be the government stimulus program, which although substantial, is dwarfed by the magnitude of consumer loans and home mortgage loans outstanding. In order to have a sustained resumption of growth, capital structures of corporations, the banks, and consumers must be re-rationalized. Debt must be restructured and reduced. Asset values must be allowed to decline to a value from which there can be a confident rebuilding. Much of the government's actions have been designed to stem these declines and defer these restructurings.

We continue to remain cautious with regard to the recently announced Treasury plans. We await price discovery and transactions that will help relieve the banks of their troubled and illiquid assets. It is likely that the banks will experience additional losses or write-offs in connection with these asset sale transactions. This will impact corporate earnings and may necessitate restructuring of bank debt and/or raising of additional equity capital, perhaps under FDIC regulatory authority.

We also question the political will of Congress to increase the FDIC borrowing limits in order to support the Treasury's loan purchase program and whether private investors in the program will attempt to use their negotiating leverage to cause the government to subordinate its equity capital position. Finally, the financial press has begun to focus on the valuation of consumer loans, commercial mortgages and commercial mortgage-backed securities on the balance sheets of the banks. These assets, many of which are not marked-to-market, are likely reflected at values that private investors would not now be willing to pay, even with the favorable financing of the government. This too will result in additional losses to be booked if assets were sold, and will discourage the banks from proceeding with transactions, further deferring the problem but not solving it.

Finally, the day of reckoning for the U.S. auto industry is rapidly approaching as the government has declined to fund the status quo without a viable plan for restructuring.

#### *Accountability, responsibility, and reality*

In light of the well-publicized errors and abuses that led directly to the current crisis, we are troubled by the discussions regarding the relaxation of the mark-to-market accounting rules for regulatory standards and financial statement accounting purposes. In valuing an enterprise one should look at the earnings track record of management over a reasonable period of time. Attention should not only be paid to successes but also to failures. It is not rational to assume that the banks will not make other bad loans and it is not credible to count assets that are illiquid and highly suspect in value at an inflated level for regulatory capital purposes. Such an approach inappropriately minimizes liquidity and solvency concerns. Further, there must be a transparent view of earnings to support the quality of bonds issued by a bank and its common stock value.

Although insurance companies are not subject to the mark-to-market rules for their commercial mortgage investments, many of them have requested TARP funds, confirming that the illiquidity and ultimate value of these assets may present a severe financial problem. We will closely monitor the developments in the area of mark-to-market and valuation accounting for non-traded assets and their impact on the banks, the overall economy, and the earnings of the financial sector.

We are also troubled by the apparent open line of credit to AIG, and question whether a better approach might have been to drill down through the counter-party exposure book and address the counter-party risk directly. We note that this would have given the markets greater transparency and may have been the reason that the government chose a different course of action.

We will continue to monitor risk premiums on investment grade corporate credit. It is uncertain as to when or whether they will return to historical norms (which clearly did not compensate investors for the risks that were much akin to those accepted by equity investors). At current levels, this increased cost of credit will burden the earnings of corporations and will slow economic growth. We note, however, that although credit spreads have widened somewhat since the beginning of the year, the variability among issuers and sectors remains high, signaling a lack of confidence particularly in the financial sector.

In order for there to be confidence in newly issued asset-backed securities, rating agencies and investors must demand that the issuers' (and underwriters') interest be synchronized with that of the investors. In particular, this means that issuers and product generators that fill the securitization pools must bear substantial risk of loss. Without this, lending practices will again deteriorate.

### *Caution ahead*

We are hopeful that the stimulus plan and the other programs aimed at supporting the credit markets will begin to ameliorate the economic downturn. Recently there have been signs of increased housing starts and sales, lower mortgage rates, and some targeted increases in consumer retail spending (albeit at lower than pre-recession levels) that together with reports of reduced inventory levels, improved bank operating earnings, and the announcement of the Treasury's plan have spurred a strong rally in the equity markets. Nevertheless, we remain cautious regarding the solvency and liquidity issues facing the banks and insurance companies and await results of the Treasury's stress tests. We will continue to look for more clarity in corporate earnings as we re-evaluate equity investing opportunities.

### *Portfolio Changes and Construction*

Entering 2009, most of our clients were significantly under-weight equities. Funds have been invested in high quality municipal bonds, diversified municipal bond funds, Treasury securities, and tax-exempt money market funds. Most clients' equity portfolios remain diversified in large-, mid-, and small-capitalization equities and over-weight in mid-capitalization stocks relative to the Wilshire 5000 total market index.

As we became increasingly concerned that perceived risks would perpetuate or widen credit spreads, we exited our diversified corporate bond holdings. We also made a determination that we would not invest in money market funds that had substantial investments in domestic bank certificates of deposit in excess of FDIC limits or in foreign bank certificates of deposit.

While we continue to look for the equilibrium point for equity market valuation, we are mindful that sometimes markets react strongly to the upside well in advance of the resumption of robust growth in earnings. This is the reason that we have maintained an equity allocation for most clients. We believe, however, that in the continued environment of heightened risk to corporate balance sheets, earnings, and the overall economy, a muted and significantly under-weight equity allocation is appropriate and has worked thus far to mitigate total portfolio losses. The S&P 500 Index at March 31<sup>st</sup> remained substantially below the level at which we made our last significant reduction in equity allocation for most clients. As each of our clients' portfolios is individually managed, please discuss your own account with your KLS Managing Director.

As always, we will continue to use our best judgment in managing the portfolios of our clients.