

# SKBA CAPITAL MANAGEMENT

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## Finding the Way Forward Through the Financial Crisis

### - the Good, the Bad & the Ugly

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#### Summary & Conclusions

The U.S. Treasury's decision on September 7 to send Fannie Mae and Freddie Mac into conservatorship was quickly followed by a chain of financial events leading to the bankruptcy filing of the venerable Lehman Brothers on Monday, September 15 and to the resulting rout in financial stocks and the stock market on the same day. Although, up until now, there's been almost no light at the end of the tunnel of the current financial crisis, we do feel somewhat fortunate in having done the correct research analysis to have avoided in client portfolios the worst of the disastrous impact from the plunging stocks of GSE's Fannie Mae and Freddie Mac, brokers Bear Stearns, Lehman Brothers, and Merrill Lynch, banks like Citicorp and Washington Mutual, and insurance companies like American International Group (AIG). This short list indicates how all encompassing the problems have become. And the consequences have moved beyond Wall Street and into Main Street.

As a result, the Treasury's decision on Fannie and Freddie was **one** significant step forward in supplying liquidity and thawing (read "ending") the credit freeze in the mortgage finance market (*The Good*), one huge trampling of private property rights (*The Bad*) with the effective nationalization of Fannie, Freddie, and then AIG and the rewarding of short sellers who contributed to the decline in shareholder confidence), and one big *Ugly* mess for Fannie and Freddie shareholders and the future of these GSE's (government-sponsored enterprises) as well as other financial institutions.

Yet there is a ray of light at the end of that long tunnel of financial darkness, and step-by-step, the Treasury and the Fed are getting their hands around the problems with mostly *Good* policy initiatives. These initiatives include the rescue of Fannie &

Freddie debt, the maintenance of a positively-sloped yield curve, the injection of liquidity into frozen securities markets, primarily for mortgage-backed securities, and the reinstatement of controls over short selling.

Yet to come, in terms of additional optimal policies and so still shrouded in uncertainty, are steps to create a national clearing house for exchange-trade derivatives to ameliorate the counterparty risk that now plagues the OTC derivatives market and the relaxation of capital requirements. Now that mark-to-market and loan losses are already posted on the books of financial institutions, such relaxation would ideally halt the tightening of credit/lending standards that are having such a negative impact on the real economy. These latter steps are likely 2009 events and yet would have a significant impact on ending the financial crisis in which we find ourselves. And this would be very *Good!* We believe the market's panic has created investment opportunities, and rather than becoming increasingly cautious, we are on the lookout for the financial companies that will be the success stories of the next 3-5 years.

If you're game for the details, read on!

#### The Role of the Federal Reserve Board and Financial Regulators

Let's step back for the moment and think about what the ideal "real" responsibilities of the Federal Reserve Board and U.S. Treasury are. The Humphrey Hawkins Act requires that the Fed seek a balance between full employment and low inflation. This combination of objectives is simply beyond the tool kit of the Fed. We acknowledge that price inflation is a monetary phenomenon, too much money chasing after the current stock of goods. But no one, not even the Fed nor the Treasury (not even

OPEC!), can control *both* the price of goods and their quantity of consumption. The Fed by itself cannot produce full employment/high real economic growth and low inflation. This is a futile game, and the Fed's confusion about its policy objectives, for which Congress must take much of the blame, has contributed much to our current financial crisis.

The Fed has three key objectives:

1. Stabilize the purchasing power of the U.S. dollar (or unit of account).
2. To the extent consistent with the first objective, stabilize the exchange value of the currency.
3. Prevent panic in regard to the stability of financial institutions (such as preventing bank runs and maintaining good regulation to spot and resolve problems).

To the extent the Fed consistently pursues these objectives, it fosters a low inflation rate, encourages appropriate risk taking (building business confidence in making long-term investments rather than speculating on commodities), and contains contagion that might generate widespread panic and loss of confidence in our financial system. In no way should directly affecting the pace of employment and real economic growth, via a stimulative monetary policy, be a primary objective.

Ge – how's it doing with these three? Doh!!!

None of the financial regulators, not the Fed, the SEC, the Treasury Department, the OCC (Office of the Comptroller of the Currency which audits banks), OFHEO (Fan and Fred's regulator), FDIC, OTS, SPIC, Congress nor even Eliot Spitzer saw this coming. Indeed, the Federal Reserve Board pursued policies under Chairman Greenspan and Bernanke that contributed to speculation and volatility in financial and real asset prices (like housing). Greenspan's decision earlier this decade to push the Fed Funds rate down to 1% (creating negative real interest rates) and to hold it there for roughly two years simply fueled the desire to own real assets and commodities. Furthermore, it generated the "need" and desire to relax credit underwriting standards (consistently fostered by Congressional mandates to relax lending standards for low-income home buyers), particularly for sub-prime residential real estate, and to create financial instruments to boost yields in such a low interest rate environment, such as CDO's (collateralized debt obligations) and SIVs (structured investment vehicles), and Auction-Rate Notes, all of which were fueled by and provided the fuel for the explosion in sub-prime mortgage

originations. This represents a *massive* regulatory and market failure that will not be solved overnight.

It is an understandably difficult task to balance the policy positions that hold the inflation rate in check (a poor job of late!) and contain the tsunami of financial panic. The Fed and Treasury Department must and are, however, addressing the issues of panic by investors and depositors that threatens the proper functioning of our financial system.

### **The Crisis in the Shadow Banking System**

One should not underestimate the long-term significance of what is happening in financial markets. For decades, traditional banking services have lost market share to securities markets. Creating mortgage-backed securities (MBS) and selling them to investors opened up an entirely new source of lending that in the past 30 years would have been funded by bank and S&L depositors. The explosion in the creation and trading of derivative securities, like credit default and interest rate swaps, and securities to capture or hedge nearly every kind of perceived risk created an entire "Shadow Banking System" (of which Fannie and Freddie were a part) virtually outside the regulatory purview of the Fed. Securities of all kinds, rather than bank deposits, funded lending activities. Rather than truly using such security innovations to reduce financial risk, participants have used them to leverage financial investments far beyond what would have been permissible for banks in their traditional lending activities. **What is occurring with today's financial crisis is nothing less than the slashing of the size of this shadow banking system (but not its elimination), resulting in a severe contraction in the availability of credit.**

Now also put aside, for the moment, whether or not you believe that Fannie and Freddie even ought to exist as GSE's. It is a worthy debate as to whether or not Fannie and Freddie's roles could have all along been accomplished by the private sector financial institutions. Yet two perspectives now seem clear. Fannie and Freddie are both one source of the problem and part of the solution to the financial crisis the market faces, as they once again become able to purchase and repackage mortgage pools into securities.

With Congressional pressure to become a conduit for low-income home ownership and with the implicit and explicit backing by the U.S. Treasury, these two GSE's grew rapidly without the same Tier 1 capital requirements faced by their private financial

institution counterparts. The systemic risk they posed became, in becoming too big to fail, a stumbling block to effective regulatory reform.

As we have examined the financial crisis facing Fannie and Freddie, all financial institutions and the country as a whole, we have pondered what policies make sense in taking the country out of its current crisis and what Bernanke and Paulson's likely course might be.

Having created an environment (with low nominal and real interest rates) ripe for speculation in risky assets (commodities, sub-prime mortgages, CDO's, & Credit Default Swaps, etc) in 2005 and 2006, huge real loss potential was brewing well in advance of the actual problems. We likened it to a slow-motion train wreck – you can see it coming far down the track well before it is suddenly rushing upon you. The losses aren't going away; so how should the regulators manage the problems?

### **The Ideal Fed and Treasury Policies**

Surely the Fed has responded to the crisis by lowering short-term interest rates. Yet, low interest rates alone are not the solution. Negative real interest rates fuel speculation in commodity prices and pressure the exchange rate of the U.S. dollar. In SKBA's humble opinion, here's a list of steps either already taken by the Fed and Treasury or which are ideal for dealing with this crisis:

- 1) Maintain a steep positive-sloped yield curve. This creates positive net interest margins for financial institutions to rebuild retained earnings and support building reserves. (now implemented)
- 2) Facilitate capital infusions into financial institutions to absorb rapid increase in mark-to-market and loan loss reserves.
- 3) Create liquidity in frozen securities markets.
- 4) Establish a true clearing house mechanism to enable the creation of standardized exchange-trade derivatives contracts to reduce counterparty risk that now exists in the OTC market.
- 5) Reinstate the short-selling up-tick rule and ban naked short selling. (requires short sellers to sell short on an up tick in a stock's price and borrow shares to sell).
- 6) Halt the tightening of bank lending standards.
- 7) Relax bank capital requirements.

So, excluding the fiscal policy issues associated with tax rates and policies, what has occurred and ideally would occur to counteract these forces that have already led to the demise of Bear Stearns and Lehman Brothers?

The credit markets have now undergone a huge repricing of risk. Indeed, credit spreads have gone from the bottom end of the historic ranges, at which the true risk of current investments like CDO's was being completely ignored, to peak levels reflecting a state of extreme pessimism. Yet, any financial institution with the capital to invest in today's market is well rewarded for taking risk. Even with rather severe default experience, mortgages are likely to have higher rates of return than suggested by the depressed valuation of even the high quality ABX indexes. By keeping the yield curve steep (with a low cost of deposits) in the face of credit spreads, those banks willing to lend should be handsomely rewarded.

So the Fed's *first* goal is/should be to create a high and positive net interest margin for lenders. Its actions to push down the Fed Funds and Discount rates have accomplished this. The risk of creating future inflation from these policies has not gone away, however, but the topics of stagflation and the earning power of financial institutions will be the subject of a future newsletter.

With financial institutions having recorded over \$500 billion of loan and mark-to-market losses, the capital bases would be simply overwhelmed were it not for the infusions of capital in the form of common and preferred equity and subordinated notes. To encourage and facilitate financial institutions in seeking new capital is the Fed/Treasury's *second* step. The dilutive impact on existing shareholders from such capital infusions has been enormous, but it has been a necessary precondition to recovery from today's financial crisis. And at the top of the list was shoring up the capital bases of Fannie Mae and Freddie Mac.

Diluting existing Fannie/Freddie shareholders by 65-75% with an equity infusion by itself did not have to be the source of causing the equity share values to plummet. A \$15-20B investment in FNM shares, even at only \$7 per share, would have diluted existing shareholders by 2/3rds, but the stocks would have risen and both existing shareholders and the government could have been winners. The GSE/MBS debt markets would have rallied just as they did immediately following the announcement, so there would not have been a loser anywhere by this

move. Instead, the Treasury decided to issue warrants that forcibly dilute shareholders with no equity infusion, and buy \$1B of senior preferred stock (also talked about as an option over the prior several weeks), but also with no immediate investment. The essential promise was to supply one more dollar than is necessary to maintain positive equity capital.

Our immediate thought was that if a concern arose from those actions, it would be among investors in financial companies that are facing some financial difficulty in raising equity capital. The unintended consequence of the Fed's action would be that equity investors, either in common or preferred stock, would be even more reluctant to make risky investments in such companies if the Treasury and/or Fed will simply unilaterally destroy their offers of risk capital to stem the crisis. Were investors who just within the current year funded large capital infusions into Fannie and Freddie with preferred stock acting in bad faith? Who now wants to offer such capital to fill the void many financial institutions face? This seems to us to be a bad precedent that could have further financial consequences for struggling financial companies (such as we've already seen with AIG).

Since Paulson has also stated that the government will receive its money back first before existing shareholders, how does this appropriately contemplate the future of Fannie and Freddie as entities? Why would the government want to specifically own them over the long term? The federal government shouldn't be in this business, as it has neither the ability to make good decisions on when and where to invest capital nor how to manage risks. If some form of Fannie and Freddie are to become private companies again, how does destroying existing shareholders become helpful in this transition? You'd think that maintaining an existing shareholder class would be a good thing, not viewed as a pariah. This is *Bad* policy, with an *Ugly* outcome for troubled financial institutions and shareholders. This does not eliminate the ability of the other policies to work to end the crisis, but it certainly was and is counterproductive.

In regards to the *third* objective, the Federal Reserve Board and the Treasury have created the Term Auction Note facility to enable distressed financial institutions to use illiquid financial instruments as collateral for loans. Expanding these facilities to a wide range of illiquid collateral and offering longer maturities would free up capital among holders and dealers in these securities. Without liquidity to create a tradable market in today's illiquid securities and

investments, no money is available to create new lending or new securities.

As a result, the recently announced plan to offer to purchase up to \$700 billion of distressed MBS and loans is an even more important step in the right direction. As one watched the debate among members of the Senate Finance Committee, however, over the size and nature of the plan and whether or not the government should get equity in such companies, one could simply see the stock market sag minute by minute. Congress never understands the unintended consequences of its laws and regulations, and these ideas are not helpful and created renewed uncertainty.

What these frozen markets need is a lasting source of liquidity, and if properly implemented, the plan is brilliant with plenty of winners, including the federal government. The market needs a reduction in uncertainty, which a full funding of the \$700 billion proposed plan would accomplish. And the Fed/Treasury needs the correct repurchase mechanism in place, which in our opinion is a reverse auction or open auction process undertaken each week or month. The financial institutions participate on a voluntary basis, so none would act contrary to its own financial interest.

The Treasury would solicit bids for a certain type of security or collateral for the purchase of \$X billion (at a time) and would purchase the "toxic" debt at the highest price necessary to solicit bids for the \$X billion. Since many MBS, CDO's, and whole mortgages have been marked to market (thanks to rule 157) using the ABX indexes, in our view, they almost certainly now understate their true value, even with today's high default risk. The Treasury's purchase would be at the "right" price that fully reflects the true default risk, and yet the securities may well be marked up from their depressed "fire-sale" valuations, possibly boosting the gains and capital of the seller. The market appropriately dictates these levels when the function of price discovery and liquidity are restored. The government liquefies the market, and the banks that gain liquidity will be able to redeploy these frozen assets into new loans and investments. Almost everybody wins.

The *fourth* step the Fed and Treasury need to take is to deal with the counterparty risk inherent in the OTC derivatives market. Matt at SKBA coined the phrase that counterparty risk was the "Voldemort" of financial market risks – for a long time, it was the risk "that dare not be named!" (Just a little Harry Potter humor!)

Gone are the days during which investment banks could lever their capital at a 30 to 1 ratio, compared to the much lower leverage of 12.5 to 1 implied by an 8% Tier 1 capital ratio required for banks. Such high leverage ratios are history for perhaps the next decade.

Also, by now everyone has recognized that in each derivatives contract, there is a winner and a loser. But if the loser is a financially insolvent counterparty, the winner cannot collect his winnings. The derivatives market has gone from being relatively cavalier about counterparty risk to now being hypersensitive about it. The clear solution to this problem is the creation of a national clearing-house mechanism that enables standardized derivative contracts to be traded on exchanges. Standardized terms on contract performance and default and better surety that counterparties have sufficient capital to pay contract claims will unlock this market. Unfortunately, neither the profitability nor the volume of derivatives contracts will ever be as high going forward as they have been in the past few years. Yet instituting such changes will unlock this frozen market place and restore normal price discovery functions. This has yet to happen but with the efforts of current working groups could see progress over the next year.

In terms of the *fifth* change, reinstating the up tick rule for short selling and eliminating naked short selling are incrementally modest positives. There's a useful function short sellers play in the market – one of price discipline. Although short selling is thought to be a counterbalance to optimistic holders of long positions, just as often, short sellers become trend followers, driving down the price of common stocks to well below their underlying fundamental valuation support. For financial institutions, such behavior creates systemic risk as the confidence in a bank or broker can be easily undermined by the rapid decline in its stock price, driven by short selling, that creates a self-fulfilling prophecy of doom. One can argue that this is what happened to Lehman Brothers. There are times in which the Fed and Treasury should restrict short selling's ability to create further systemic crisis, and the recent decision to ban short selling (even if only over the short term) in financial stocks is a step in the right direction.

As banks are forced to both protect capital and raise it as loan loss reserves are increased, the natural response is to tighten lending standards. Too bad they didn't think of doing this in 2005 and 2006! There is a lagged relationship between the tightening (easing) of bank lending standards and the rise (fall) in net

charge-offs 12 plus months later. With the sharp rise in the number of banks reporting tightening lending standards (nearly 60% for commercial loans), defaults on loans in general, not just residential mortgages, will continue to plague bank capital positions. This is a self-reinforcing, pro-cyclical activity by banks – tightening lending standards contributes to rising default rates for otherwise financially sound customers.

Therefore, the *sixth* objective of Federal Reserve and Treasury policies should be to halt the further tightening of lending standards by banks. Of course, they cannot order banks to lend and at the same time order them to strengthen their capital bases. Shoring up bank and investment bank capital has been and is an appropriate goal during this phase in which rising mark-to-market and loan losses are destroying capital ratios. But every loan loss reserve increase reduces future risk. Yet the losses reduce retained earnings (part of capital) even though loan loss reserves, net of expected charge offs, are part of a bank's Tier 1 capital ratio. With over \$500 billion in reserve increases and over \$400 billion of capital raised, there comes a point at which the further requirement to raise capital prolongs the downward spiral in lending and in the willingness to lend.

In our view, at the appropriate time, the Fed/Treasury could bring an end to this downward spiral by allowing banks to lower their Tier 1 capital ratios below the 8% Basel II requirement. So this is the *seventh* step in the process of restoring the normal functioning of the financial markets. The recognition that reserves have become sufficient or that the ongoing process of building further reserves does not exceed ongoing net income (pre-reserve expense) would mean that there isn't the same need to inject further capital just to fully restore an 8% Tier 1 capital ratio.

Here's an example of the leveraged impact such a policy change might have on freeing up capital to lend. According to Federal Reserve Board statistics, U.S. commercial banks had \$11.1 trillion of assets and \$1.2 trillion of net worth at the beginning of September. These are not risk-adjusted assets nor the proper measure of capital that goes into the calculation of Tier 1 capital ratios. Yet if the capital ratio required were lowered by 0.5% of assets from the current ratio of net worth to total assets, bank investments and loans could rise by \$0.6 trillion. Financial institutions would not be forced to further contract their balance sheets to maintain required capital ratios.

Normally, the peaking of delinquencies and non-performing assets (NPAs) triggers bank decisions to stop tightening lending standards, but the Fed could accelerate this process by lowering capital requirements at the right time. When is this? With residential mortgage write-downs (building reserves) mostly behind us but with consumer credit card, commercial real estate and commercial/industrial loans not yet experiencing a peak in building reserves for future losses, this step probably cannot occur before early 2009. If instead regulators pursue only a policy to punitively punish shareholders and force financial institutions to only focus on marking assets to unrealistically low values (based on indexes like the ABX), it's going to stay **Bad** for much longer than necessary.

One should be encouraged, however, that a number of positive steps have already been taken and that huge loss reserves have been established. The road map to recovery seems clearer than it was a year ago, but the financial distress currently underway is not over. The catharsis creating a bottom in financial stock prices, however, appears much closer than the

peak in reserves and charge offs. Yet we believe now is the time to plan for new stock purchases in the financial sector, while financial markets are in an **Ugly** mood and prone to panic.

Many big banks will be big winners from this as checking and savings deposits once again become a preferred way to raise capital for lending. And the freeze in the mortgage markets has begun to come to an end. In fact, at the beginning of September in our institutional bond portfolios, we purchased Fannie and Freddie MBS for the first time this decade!

So create your checklists and mark your calendars. We should not discount the possibility that the steps already taken by the Fed and the Treasury truly represent the beginning of the end of the financial crisis in this country. And this is **GOOD**.

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