CAS FINANCIAL ADVISORY SERVICES

FEBRUARY 23, 2010 ISSUE 25

State of the Market 25:
The past decade's biggest invisible stories

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When the naughty Aughties' history is written, what will be its major financial and economic causes?

We can see the spiky plants that have grown up through our economy – among them, the GSE conservatorship, the shotgun marriage of Bear Stearns to JPMorgan, Lehman Brothers' collapse, TARP, and the ARRA stimulus bill. What were the seemingly innocuous seeds that led to this *feed-me-feed-me* growth?

And they happened right before your eyes

1999: Fannie Mae grows its balance sheet

Starting in 1999, under the leadership of Franklin Raines, Fannie Mae pursued higher market share, higher US homeownership, and higher earnings with an eerie (and as we now know, fallacious) earnings stability, leading Fannie ever farther out on the risk limb that certainly seemed sturdy—at least near the trunk.

2000: David Li's risk-estimation function

By no stretch of the imagination was Mr. Raines unusual – nearly every financial wizard, on or off Wall Street, was similarly enraptured with the wealth machine that was the decade's global capital markets. It was all driven by the seductive belief that risk could be quantitatively controlled by hedging strategies, among them, most notoriously the Gaussian copula function of David X. Li. His arcane formula was used as the justification for gargantuan increases in counterparty risk and an explosion of Credit Default Swaps. His formula assumed independence of risks that were actually correlated—as if plants in the same garden don't all wither from the same extended drought.

2001: The dematerialization of capital

Remember when banks actually stored money in vaults, and at least had to sweat to fake capital reserves? By the beginning of the new century, capital was evidenced by matching sets of numbers contained in bank and financial institution computers. With dematerialization, capital was ineluctably and irreversibly global. Ten years later, we still haven't come to terms with capital's evanescence, as it has revolutionized and intertwined currency and investment flows.

2002: The global yield starvation

The dematerialization of capital made money into a desperate yield-sucking wraith, stalking the globe in search of bigger numbers. Nowhere was that hunger greater than in aging Europe and Japan, whose ever-more-generous social welfare system kept expanding beneficiary expectations (earlier retirement) even as it was shrinking the contributor pool (fewer workers). Yield hunger drove European and Japanese capital out of their own markets and into ours. The more desperate yield wraiths crowded in, the lower they drove the very yields they

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were seeking—and the more exotic the financial products that fed them became. The resulting cheap credit drove up prices of financial assets like loans on single-family homes, while simultaneously creating new financial securities based on these mortgages.

2003, January: Issuance of FIN 46 (later FAS 167)

In January, 2003, seeing a problem approaching, the Financial Accounting Standards Board (FASB) issued the inelegantly named *FASB Interpretation Note (FIN) 46, Consolidation of Variable Interest Entities – an interpretation of ARB No. 51.* A response to the Enron shenanigans, FIN 46 sought to prevent sponsors from playing hide the ball with risk. The FASB created a paternity test for financial offspring, changing the consolidation definition from control (which could be manipulated or obfuscated) to variability (upside and downside). Unfortunately, in seeking to make things more transparent, FIN 46 in fact made them more opaque. While investors basked in the illusion of transparent consolidation, in reality they were absorbing ever more risk – via CDO's and CDS's.

2003 onward: Explosion of unlicensed insurance: Credit Default Swaps

As compared with other complex securities, credit default swaps were (and are) especially dangerous, because they introduce two new risks that the markets proved unable to appreciate.

1. *Infinite replication means infinitely diluted credit-worthiness.* CDSs are side bets. Disconnected from the direct participants' capital, they can be written in any desired multiple of the company's market capitalization.

2. *Financial incentive to kill a company.* If enough CDSs are written where hedge funds (say) profit from a company's demise, and the target is subject to capital requirements, then there is a serious *Dial M for Murder* risk: giving third parties a financial incentive to do in another.

2006, September: Issuance of FAS 157

In 2006, as owners began to doubt the value of what they had so eagerly acquired, the FASB – which had already tweaked the rules with FIN 46 – unwittingly not only confirmed the markets' worries, but institutionalized and monetized doubt. In September, FASB issued Statement 157, which imposed a three-level test: Level 1 for assets with observable market prices (traded stocks); Level 2 for no observable price but observable inputs (interest-rate swaps whose components are observable, like the price of a 10-year Treasury); and Level 3 for assets where one or more inputs had no observable price.

The reality, underappreciated by FASB and the marketplace, is that most complex structured positions have many variables of independence. In the absence of a highly thick market in such assets, *none* of them can be valued with Level 1 or Level 2 approaches, throwing the CFO and auditors back into the realm of estimation. FAS 157 took effect November 15, 2007, which proved exactly the *wrong* time to ask financial institutions to value illiquid complex positions. An asset-valuation meltdown of sorts occurred.

2006+: GSEs' buying strategy shift … into subprime buying

Throughout the decade, Fannie Mae had embarked on an (outwardly successful) ambitious plan to grow volume and profits, through balance sheet turbocharging. When Mr. Raines gave way to Daniel Mudd, when many (like Countrywide) were reducing their exposure to subprime lending, Fannie Mae and Freddie Mac increased theirs. As reported in *Inside Mortgage Finance*, June, 2007:

> Said Eileen Fahey, a managing director in Fitch's financial institutions group, "Given the market over the past two years, they are interested in changing their portfolios

> and assuming new risks. They've moved away from the management of interest rate risk as their primary method of earning money and are shifting more toward credit risk."

Read with the benefit of hindsight, that sentence is especially frightening. Having inched out onto a creaking limb over the previous half decade, the GSEs decided to climb out farther to get away from the annoying sound.

2007: The capital markets' Minsky moment

Named for economist Hyman Minsky, a 'Minsky moment' is when previous stability itself causes massive prospective *instability.* Before February, 2007, the capital markets were contended and placid. Not only were spreads narrow, they were extraordinarily stable; the entire world thought risk was low, continuous, and anticipatable. That very stability of perceptions bred its own instability of reality.

In August, 2007, risk spreads exploded – thought it took months for many of us to understand this. For me enlightenment struck in October, 2007, when I was pitching a new investment-fund opportunity to a large financial institution, explaining how I thought we were so shrewd buyers we could deliver an 8% yield, only to be told that we needed to 14% or more.

It's one thing to be off by fifty or a hundred basis points. When you're 600 basis points apart, don't even bother to show up.

2007: Repeal of the uptick rule

During the summer of 2007, as the credit crunch deepened and the decline in asset values started to accelerate, the SEC inexplicably did the equivalent of severing the runaway automobile's brakes: it repealed the 'uptick' rule, which helped limit downward spirals by allowing a stock to be sold short only after a rise (an "uptick") from its immediately prior price. If you're afraid a precariously anchored system might come loose and go runaway, it's wise to have a self-locking ratchet. The uptick rule did that – it automatically blocked short selling that would pile on a falling stock.

Mix the potential for bear raids with the FAS 157 marking to market rules with the explosion in Credit Default Swaps and you have a powerful explosive. Realizable values of structured assets collapsed to fire-sale prices. Those discounts became the bludgeons of FAS-157-driven writedowns. The financial bombs could also be aimed. One by one Wall Street's financial pillars – Bear Stearns, Lehman Brothers, AIG, and Fannie Mae – suffered bear raids. Billions of capital disappeared even as some capital migrated to the raiders. Finally, in April, 2009, the SEC restored the uptick rule.

2008: HERA's grant of GSE seizure powers

In the summer of 2008, Congress enacted the Housing and Economic Recovery Act of 2008 (HERA), which completed a fundamental revolution in the nation's fiscal relationship to the GSEs. For most of two decades, the Federal government had been able to allow the inference – but never confirm or deny – that it would stand behind the GSEs' securities. With HERA, that peekaboo was over: the GSEs, said HERA, are too big to fail, and we will protect them if we have to.

At the time, I thought it was a good move. I was wrong. In being wrong, I had good company, starting with Treasury Secretary Hank Paulson, who later ruefully admitted that Congress had given Treasury too many powers, and their grant forced their use. Less than ninety days after being granted its powers plenipotentiary, Treasury had to use them, placing the GSEs into conservatorship, where they remain today.

2009: California's IOU issuance

In July, the state of California did an extraordinary thing: it repudiated its debts. Instead of paying its bills with cash, the state printed paper, backed by nothing, and ordered people to accept it. To be sure, the state dressed up this reneging on its debts with flowery language, calling them 'registered warrants' and making them redeemable 'by the state treasury only when the general fund has sufficient money.' As I wrote in *State of the Market 23*:

As a thought experiment, California has already met the standard "Event of Bankruptcy" definition contained in most partnership agreements – acknowledgment in writing of inability to pay its debts via the issuance of those questionable IOUs.

During the next five years, hundreds if not thousands of cities, states, provinces, and countries that are now technically insolvent are going to have to reel in their spending habits. They will choose from the following unpalatable and limited menu:

- *Overtly*, through legislative changes announced to their citizens.
- *Coercively,* through involuntary taxation or confiscation.
- *Abruptly,* through default and bankruptcy.
- *Underhandedly,* through conscious inflation.
- *Ruinously,* through hyperinflation.

Whatever they choose, it must be something: the Law of Economic Gravity will not be denied.

2009, August: President Obama's reappointment of Ben Bernanke

Long, long ago, an investment professional in whom I've always had confidence told me, "Adjusted for inflation, no government bond has ever yielded above par." That is, no matter what rate the government pays you on its bond, the actual net present value of those future payments is less than the cash you started with. The reason is simple – government influences the inflation rate. So while government may pay you the stated interest, runs the theory, it has always deflated the value of those payments faster.

Throughout the fall and winter Chairman Bernanke lay low, because like his predecessor Alan Greenspan, he knew the Fed chairman's world is divided into two periods: when one is seeking appointment, and the rest of the time. With his reappointment – forget the 70-30 'narrow' vote margin, a win is a win – he succeeded in preserving not just his job, but also its clout – meaning the Fed's independence. I believe he will set out to raise interest rates, and inflation, as the sole means of curtailing our overextended government.

What will the next decade bring?

Even though past performance is no guarantee of future results, the future does flow out of the past, both its forces and how we perceive them and hence react to them. While my crystal ball is no clearer than anyone else's, I'm struck by how much of our past decade can be explained by seemingly abstruse formulas, rules, or treatments of complex financial instruments.

Ergo, we ought to pay very close attention to any pronouncements emanating from the OCC, FDIC, Treasury, FASB, SEC … more than ever, with government so heavily invested in all levels of the financial sector, it's critical to understand the rules before they are written, preferably in hopes of identifying likely unintended consequences … and heading them off through reasoned advocacy to the regulators.