MARKET FLASH

FOR THE CLIENTS OF THE ALDER FINANCIAL GROUP, INC.

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And Then There Were Two

2008 will undoubtedly be remembered as the year the face of the U.S. financial system was redrawn. With the failure of Lehman Brothers and the acquisition of Merrill Lynch by Bank of America, only two independent investment banks remain in this country – Morgan Stanley and Goldman Sachs.

What began last year as a housing market collapse has spread into every corner of the global financial system. We have previously written about the trickling of housing troubles into the credit market, and the events of this summer are just a continuation of that process. But now, the magnitude of the fallout is a new development.

This month alone we have seen the failure and subsequent takeover of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, the sale of Merrill Lynch to Bank of America, and the Treasury bailout of AIG. The ripple effects continue to raise questions about the solvency of Washington Mutual and the viability of Morgan Stanley's independence.

As much as these events make the world seem to be spinning out of control, the underlying problems can really be distilled down to three areas: complexity, leverage and counterparty confidence. We believe that the housing meltdown was the primary contributor to this crisis, but it was also the catalyst that exposed the weaknesses in the overall credit system.

Over the past decade, the once obscure world of derivatives and hedging has grown to dominate the credit market. Years ago credit default swaps (CDS) were used to insure against financial losses when one company lent money to another. CDS's gave large lenders the ability to off-load credit risks from their balance sheets. With those risks gone, lenders then had the ability and willingness to make more loans. CDS's were simply an insurance policy. And like most insurance policies, they were hugely profitable to the issuers because defaults rarely happened.

These profits quickly caught the attention of other financial institutions and the number of contracts grew. In addition, a notional market for these contracts developed so that participants were able to trade these instruments with one another. This created a strong environment of financial interdependence among various institutions. Basically, this is how the credit default swaps market works:

Imagine company A loans money to company B. Company A buys a CDS from company C to off-load the risk that company B will default. C sells this packaged credit risk (or CDS) to company D who buys many other CDS's thinking that the economy will expand, which will improve the overall default rates and increase the general value of CDS's. Maybe company D borrows the money to buy these and more CDS's are created by more companies as a result.

You can quickly see how the fate of everyone involved is connected. Not only do you have to worry about doing business with company D but also anyone else that does business with company D. Company A supposedly offloaded their risk of company B defaulting, but what if the owner of that CDS can't make good on the contract? Company A, B, C, and D are all in trouble.

Furthermore, when these contracts are created the guarantees must be backed by capital. This capital is used as a backstop should a default occur, and thus the value of this capital is an important component in the transaction. This capital is not cash sitting around. Instead, companies often hold capital in other investments such as bonds.

While this is a relatively simple example, it is easy to see how all these firms become dependent on one another. It also gives some insight as to why the market reacts so violently when one of these participants fail. We have now seen several very large participants in this market go under, which has led to a real and justified lack of confidence in the financial system.

Magnify all of these relationships with leverage, and you have nothing but a recipe for volatility. In many cases these firms' leverage ratio exceeded 30 to 1. This means that for every $1 in capital a firm controlled $30 of securities. With that level of leverage and interconnectivity in the system, troubles with a limited number of institutions can quickly cascade into a systemic problem.

To be clear, the CDS market does play an important role in an efficient credit system. It is an effective mechanism by which the market can collectively render an opinion on the credit worthiness of companies beyond the traditional credit rating agencies. However, it is a largely unregulated and opaque market with no central exchange.

Fortunately, there is one financial institution which has the full confidence and sheer size to make a difference, and that's the Treasury. The US Treasury has been called to the rescue more than once for this very reason. Whether the term "bailout" accurately applies in all of these situations, the Treasury has been very effective in putting out the fires over the course of this year starting back in the first quarter when it orchestrated the merger of JP Morgan and troubled Bear Sterns.

The Plan

While fighting fires is important, the Treasury has not addressed the fundamental problems that have kept the markets on edge. Knowing this, the Treasury has announced a plan to essentially remove many of the riskiest securities from the market place.

The details have yet to be finalized, but in general the Treasury will create a fund that will buy these securities at some price to unfreeze the market in these instruments. In essence they will make a market where one no longer exists for an estimated $700 billion in securities. So with this giant group of securities removed from the balance sheets of so many companies, faith will be restored in the capital level and solvency of each counterparty.

The debate over this plan is currently in full swing and as such there is a lot of information being reported that is wrong, incomplete, or misleading. It is also obvious that all but a few politicians, including both presidential candidates, have very little understanding of what is going on. The Fed and Treasury, however, have a very good understanding of the situation.

Let there be no doubt that the numbers being thrown about are extremely large. That being said, it is wrong to say that the government is going to "spend" $700 billion. They are in fact going to purchase several hundred billion dollars of bonds. While a lot of these bonds have bad loans wrapped inside them, the vast majority of these securities are currently performing as expected. No one knows what these things are worth or what the government is going to pay for them, but one thing is for sure; the government will be buying these securities at a steep discount.

This actually presents an interesting situation. Through the treasury market, the federal government has access to the cheapest money in the world. They are going to use those funds to buy income producing securities that are surely yielding higher than the government's borrowing cost. Ultimately, the level of defaults realized in the future will determine the actual cash flows. But it is very hard to imagine how the Treasury can't *profit* from this plan.

The high likelihood that the Treasury will make money on this plan has been downplayed because it is a politically sensitive issue, but it is worth noting that this is the same business model that has made huge profits on Wall Street. The difference is that unlike Wall Street, the Treasury can not get squeezed on the short end and forced to sell. There is a saying on Wall Street that goes, "The market can stay irrational longer than you can stay solvent." That does not apply to the Federal government.

The Blame Game

Plenty of people are plenty mad. Shareholders are angry over diminished portfolio values. Politicians are unhappy about the state of the economy. Homeowners are upset over their declining property values and foreclosures. Now tax payers are being told the deficit is going to skyrocket because "Main Street" is having to bailout "Wall Street".

This is a huge mess for sure and it has done a lot of harm to the image of our country in the eyes of the global financial community. But there is plenty of blame to go around.

Let's start with Wall Street. There is blame on two fronts. First, Wall Street has spent years inventing ever more complex financial instruments without fully vetting them in a stressful environment. Not only did companies sell these securities to others but they then held them on their books. Secondly, the risk management department in all but a few investment banking firms had become complacent and incompetent. We suspect the brightest minds are working in private equity and hedge fund firms and not the major brokerage houses.

Next, let's not forget who took out all of those bad loans and drove up property values to insane levels. You are going to hear a lot of talk in this election year about poor victimized "Main Street." Actually, this started on Main Street. The mortgage industry merely gave these folks the rope with which to hang themselves. Flipping houses became the new career path for many. Television was full of "flip this house" programming and no money down real estate schemes. Loans were taken out by Joe-next-door lying about his income. To debunk the "poor mistreated Main Street" idea, the increase in foreclosures is in new purchases where the person taking out the loan never could afford the house long-term, the person knew this but did not care, and instead planned on flipping it before they ran out of money.

Finally let's look at the role of government. This crisis has not been due to a failure to regulate. There are major regulatory changes that need to be made, but mostly the changes need to promote standardization and transparency in new markets. If this mess was due to a regulatory failure, then why is it that the least regulated firms (private equity and hedge fund firms) seem to be holding up the best? On the other hand, the center of the storm is within the much regulated banking, brokerage and insurance industry.

Then there is the issue of home ownership. Politicians have for years been pushing home ownership to the masses, and they have been using their influence to force the lending industry to comply. In hindsight it is becoming clear that there is a group of people out there that is really meant to be renters. Homeownership is not in the Bill of Rights and maybe requiring a substantial down payment and healthy credit is a good idea after all.

I came across a good article in the Wall Street Journal written by Mr. Calomiris, a professor of finance and economics at Columbia Business School. I wanted to share it here because it does a good job of enlightening us as to the government's role in this mess. Try to remember this when our elected officials express their rage to the media.

Many monumental errors and misjudgments contributed to the acute financial turmoil in which we now find ourselves. Nevertheless, the vast accumulation of toxic mortgage debt that poisoned the global financial system was driven by the aggressive buying of subprime and Alt-A mortgages, and mortgage-backed securities, by Fannie Mae and Freddie Mac. The poor choices of these two government-sponsored enterprises (GSEs) -- and their sponsors in Washington -- are largely to blame for our current mess.

How did we get here? Let's review: In order to curry congressional support after their accounting scandals in 2003 and 2004, Fannie Mae and Freddie Mac committed to increased financing of "affordable housing." They became the largest buyers of subprime and Alt-A mortgages between 2004 and 2007, with total GSE exposure eventually exceeding $1 trillion. In doing so, they stimulated the growth of the subpar mortgage market and substantially magnified the costs of its collapse.

It is important to understand that, as GSEs, Fannie and Freddie were viewed in the capital markets as government-backed buyers (a belief that has now been reduced to fact). Thus they were able to borrow as much as they wanted for the purpose of buying mortgages and mortgage-backed securities. Their buying patterns and interests were followed closely in the markets. If Fannie and Freddie wanted subprime or Alt-A loans, the mortgage markets would produce them. By late 2004, Fannie and Freddie very much wanted subprime and Alt-A loans. Their accounting had just been revealed as fraudulent, and they were under pressure from Congress to demonstrate that they deserved their considerable privileges. Among other problems, economists at the Federal Reserve and Congressional Budget Office had begun to study them in detail, and found that -- despite their subsidized borrowing rates -- they did not significantly reduce mortgage interest rates. In the wake of Freddie's 2003 accounting scandal, Fed Chairman Alan Greenspan became a powerful opponent, and began to call for stricter regulation of the GSEs and limitations on the growth of their highly profitable, but risky, retained portfolios.

If they were not making mortgages cheaper and were creating risks for the taxpayers and the economy, what value were they providing? The answer was their affordable-housing mission. So it was that, beginning in 2004, their portfolios of subprime and Alt-A loans and securities began to grow. Subprime and Alt-A originations in the U.S. rose from less than 8% of all mortgages in 2003 to over 20% in 2006. During this period the quality of subprime loans also declined, going from fixed rate, long-term amortizing loans to loans with low down payments and low (but adjustable) initial rates, indicating that originators were scraping the bottom of the barrel to find product for buyers like the GSEs.

The strategy of presenting themselves to Congress as the champions of affordable housing appears to have worked. Fannie and Freddie retained the support of many in Congress, particularly

Democrats, and they were allowed to continue unrestrained. Rep. Barney Frank (D., Mass), for example, now the chair of the House Financial Services Committee, openly described the "arrangement" with the GSEs at a committee hearing on GSE reform in 2003: "Fannie Mae and Freddie Mac have played a very useful role in helping to make housing more affordable . . . a mission that this Congress has given them in return for some of the arrangements which are of some benefit to them to focus on affordable housing." The hint to Fannie and Freddie was obvious: Concentrate on affordable housing and, despite your problems, your congressional support is secure.

In light of the collapse of Fannie and Freddie, both John McCain and Barack Obama now criticize the risk-tolerant regulatory regime that produced the current crisis. But Sen. McCain's criticisms are at least credible, since he has been pointing to systemic risks in the mortgage market and trying to do something about them for years. In contrast, Sen. Obama's conversion as a financial reformer marks a reversal from his actions in previous years, when he did nothing to disturb the status quo. The first head of Mr. Obama's vice-presidential search committee, Jim Johnson, a former chairman of Fannie Mae, was the one who announced Fannie's original affordable-housing program in 1991 -- just as Congress was taking up the first GSE regulatory legislation.

In 2005, the Senate Banking Committee, then under Republican control, adopted a strong reform bill, introduced by Republican Sens. Elizabeth Dole, John Sununu and Chuck Hagel, and supported by then chairman Richard Shelby. The bill prohibited the GSEs from holding portfolios, and gave their regulator prudential authority (such as setting capital requirements) roughly equivalent to a bank regulator. In light of the current financial crisis, this bill was probably the most important piece of financial regulation before Congress in 2005 and 2006. All the Republicans on the Committee supported the bill, and all the Democrats voted against it. Mr. McCain endorsed the legislation in a speech on the Senate floor. Mr. Obama, like all other Democrats, remained silent.

Now the Democrats are blaming the financial crisis on "deregulation." This is a canard. There has indeed been deregulation in our economy -- in long-distance telephone rates, airline fares, securities brokerage and trucking, to name just a few -- and this has produced much innovation and lower consumer prices. But the primary "deregulation" in the financial world in the last 30 years permitted banks to diversify their risks geographically and across different products, which is one of the things that has kept banks relatively stable in this storm.

As a result, U.S. commercial banks have been able to attract more than $100 billion of new capital in the past year to replace most of their subprime-related write-downs. Deregulation of branching restrictions and limitations on bank product offerings also made possible bank acquisition of Bear Stearns and Merrill Lynch, saving billions in likely resolution costs for taxpayers.

If the Democrats had let the 2005 legislation come to a vote, the huge growth in the subprime and Alt-A loan portfolios of Fannie and Freddie could not have occurred, and the scale of the financial meltdown would have been substantially less. The same politicians who today decry the lack of intervention to stop excess risk taking in 2005-2006 were the ones who blocked the only legislative effort that could have stopped it.