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Bailouts Not Enough

Egan-Jones' Sean Egan Calls For Structural Reforms, ASAP

If there's anyone out there who truly has not *been surprised by the toxic waste that's been turning up all over the globe ever since start of the Great Credit Unwind, it's got to be* **Sean Egan**. *The founder, with partner* **Bruce Jones** *of the creatively named* **Egan-Jones Rating Co.**, *Sean has been butting heads with Wall Street, its pliant regulators and its institutional clients for almost 20 years now, trying to sell them on the notion that* independent *credit research — not commissioned and paid for by the guys packaging and selling the stuff — might actually be a good thing. Might actually help investors avoid black holes in their balance sheets — because his analysts were finding financial WMDs wherever they looked in the Street.*

It was a tough slog, albeit not without its rewards. Especially lately, as Egan-Jones clients have benefitted from early, and accurate, warnings about many of the most volatile and incendiary issuers trapped in the giant leverage melt. Sean first sounded a tocsin on the credit mess in these pages back in mid-2006 and followed that up early this year with some insightful analysis of the monoline's demise.

I called Sean last Friday, as the Citigroup rumors swirled, to ask, what's next. Listen in.

KMW

The crises just keep coming. Citigroup has been the flavor *du jour.*

I know. What was it? **General Motors** and **Ford** earlier this week? The situation with Citi is the government – or some other source – is going to have to inject between $50 and $100 billion within the next couple of days or they will be forced to sell themselves. They've already raised money from Sovereign Wealth Funds, and lost credibility because of the massive declines in their share price. So they needsome deep-pocketed, stupid investors and at the top of the list is probably the Federal government.

[The taxpayers' latest capital infusion turned out to be $20 billion – plus a federal guarantee of some $300 billion in toxic assets. *Reacting to Citi's latest dose of corporate welfare, Sean said early this week: "It's just the latest example of the miserable risk assessment systems that Citi had internally and the fact that they were relying on some external conflicted ratings. It shows the level of damage that can be done by misplaced faith. And I don't think that the $306 billion that the government is backstopping, or the additional $20 billion in capital it's injecting, although it sounds like a huge*

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Victor Juhasz
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amount of money — and is, in an absolute sense — is enough. Not relative to Citi's balance sheet which is north of $3 trillion in assets. It would have been better if they had put in real capital to come up to 8-10% of assets, which is what we're going to have to get to, eventually. It would be better not to dribble it out."]

It's a fine fix the financial system is in.
The thing is, even someone who has only recently awakened from a five-year coma has seen enough evidence within the past couple of months to realize that we have structural problems that have to be addressed. If you sit back for a minute, you see that three of the five investment banks are gone and the other two have ducked under the commercial banking umbrella. You have witnessed the demise of most of the monoline insurance industry and you have seen the failure of the largest insurance company, in the form of **AIG**, the largest mortgage banker, in **Countrywide**, and now, you are seeing the transformation one of the largest banks, in Citi. Forget **WaMu** and **Wachovia**. They just add to the story. I assume that **KeyCorp** and some of the other regional banks won't be far behind. The problems clearly are structural problems, and we hope that **Tim Geithner** will be able to address them over the next couple of months.

"Everyone should play their own position. The investment banks can create anything they want. That's what they do. It's up to, No. 1, the rating firms and maybe No. 2, the regulators (who were taking far too much of a *laissez faire* approach), to pass on this stuff before it goes out the door."

I'm pulling for the whole Obama team, but none of them can walk on water.
No, he can't, you're absolutely right. And the Fed can't bail out everybody. They can bail out a few parties, but can they go much beyond **General Electric** and **Citicorp**? It seems as though the bailouts don't extend to the auto companies, at least based on my latest reading of things.

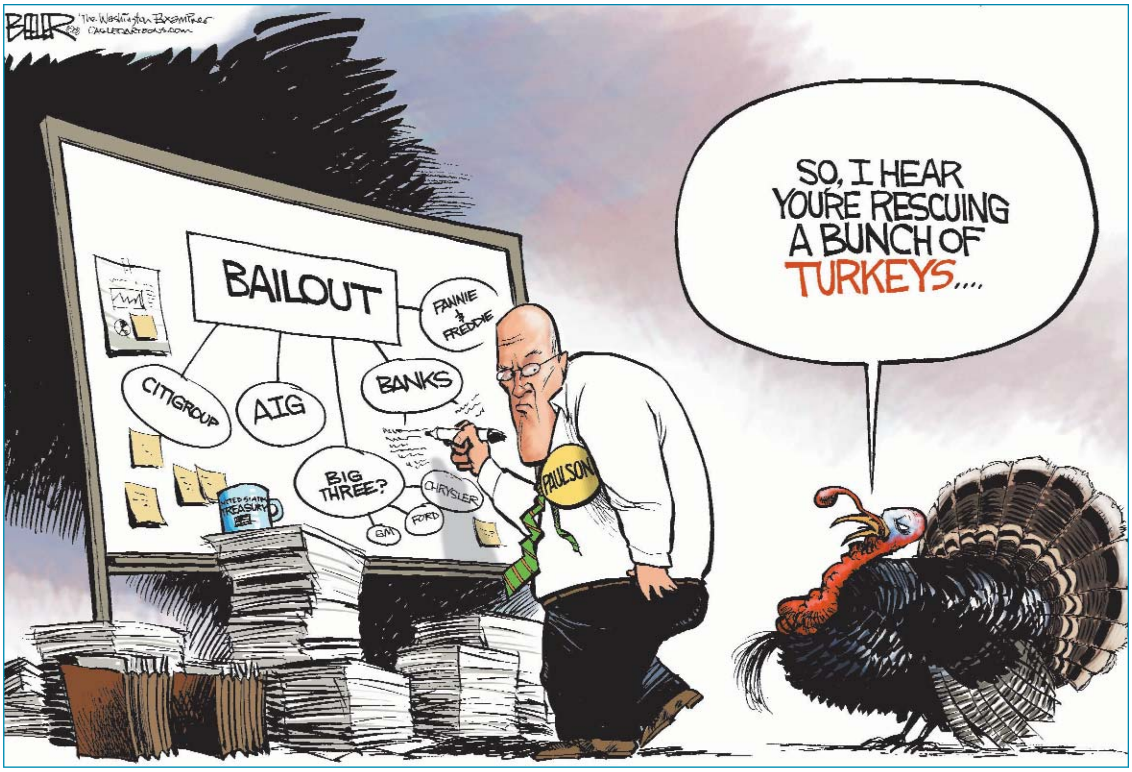
It doesn't sound like it. They were floating trial balloons about the notion of prepackaged bankruptcy again this afternoon. But I can't see Obama writing off the Midwest.
Well, I think that from a political standpoint, a bailout of the Big Three doesn't work. The autoworkers are paid about $75 an hour and even if their plants shut down, their contracts say that they still get paid close to $75 an hour. The Federal government asking the taxpayers to support that, I just don't think that flies, from a political standpoint. Until that is changed – which won't be changed without a bankruptcy – I don't see the Federal government doing more than supplying them with minor unemployment benefits and job training. The auto companies have so far to go to become competitive that I don't think a bailout would be the answer for them, even if they did receive it.

Agreed, the restructuring and rationalizing that needs to take place in Detroit is far more drastic than the CEOs seemed to be contemplating when they went hat in hand to Congress. They still don't get it.
I agree.

I don't think we can afford to give up on manufacturing. But we can't afford to keep the status quo in Detroit on life support, either.
Especially not when GM is bleeding. It used to be $2 billion a month and I think it's probably closer to $3.5 billion, given the decline in the sales level.

You've made a lot of great calls about the credit morass, Sean. But are your clients starting to mutter about you never seeing the bright side or anything like that?
No, in fact, quite a few have told us they're just thrilled because of the way that calls like saying there was no way that **MBIA** and **Ambac** were AAA's – back when they were trading around $70 or $80 a share – have turned out. Those

were nice shorts and a lot of clients were very happy with that stance. There have been lots of others, so overall our call on the financials has been the right call. Now we're just looking for a few things before we can turn positive. We hope to see some structural changes, some checks and balances. Who knows whether they'll happen, but hopefully they will and we'll become positive. But in the meantime, most of our positions are still negative.



I don't think I've seen an upgrade coming out from Egan-Jones in quite some time —
They are far and few between.

In fact, it seems like your analysts are racing to keep up with the deterioration in some situations.
I know, I know.

The interconnectedness of the financial system, on a global scale, continues to surprise lots of people. Few realized how incestuous all the leverage made it.
Oh, it's incredible. Some people thought China could stand on its own two feet. Well, good luck. It can't. Especially when a lot of its manufacturers have razor thin margins and their primary customers are No. 1, the United States and No. 2, Western Europe. When either of those goes away, the marginal profit turns into a wash. The Chinese are in the exact same position as us, although they obviously have greater reserves built up. The global economy is still very interconnected.

So what kind of structural changes do you want to see?
Well, the first is something we've been pushing for quite some time. We hope that it will happen now, because of the credit crisis – even though we obviously would have preferred it to happen a long time ago, when this might have been avoided. The point is that at the core of this credit crisis are all sorts of faulty assumptions about underlying credit quality, particularly in the structured finance area. And because of those faulty assumptions, it turns out that a lot of financial institutions don't have the wherewithal to absorb the losses they are now experiencing. Our view is that there should be some credit agents or rating firms *whose interests are aligned with the underlying investors*; who are not paid to issue false, inflated ratings. Who don't belatedly wake up, as was the case with AIG, and slam it down three notches which required a $14 billion collateral posting – and which AIG couldn't come up with. There have to be some checks and balances so that you don't have these serial failures in the marketplace, because things that were thought to be AAA turned out not to be anywhere near that. That was especially dangerous because, given inflated ratings, financials institutions were able to carry such high leverage. Which meant they had no place to hide when the storm came, in terms of the asset declines.

No doubt, your rivals in the ratings business — the ones paid by issuers instead of by investors, like your firm — were key enablers of the financial alchemists who (temporarily) turned dross into AAA gold.
In fact, if they had not let the stuff go out the door, it would have been a major positive. If they, for instance, had forced **Lehman Brothers**

via a credit rating notice to raise more capital, that would have been a huge positive. And if they never rated some of these SIVs at AAA, that Citibank has taken back on its balance sheet after they got slammed down to D, it would have been a huge positive. Just think, the **Reserve Fund** could hold Lehman Brothers at the A+ level, but when it failed, they had to break the buck. A lot of this pain would have been avoided if the ratings hadn't been inflated. Not all of it, certainly. But I don't think you can just blame the Federal Reserve because they held interest rates low for so long. Guess what? They're low again, so that's not a good explanation. Nor do I think it's sufficient to say that the investment banks should have known better themselves and raised more capital. The guys who had the expertise were the issuer-paid credit rating firms. So they were a primary cause. Maybe not the *only* cause, but it's hard to say they weren't an integral part in this whole meltdown.

They were integral, all right. But I question whether the rating agencies really had the expertise. Only the investment banks knew what they were putting into their securitization packages — and they evidently didn't enquire too closely of their suppliers, either. The emphasis was volume, not quality.

In retrospect the rating agencies absolutely didn't have the expertise – and that was part of the problem.

As was their compensation structure, which gave the rating agencies every incentive to rubber stamp the rocket scientists. And the result was weapons of financial mass destruction, supercharged with unthinkable levels of leverage. All those derivatives were rationalized — and even blessed — by regulators as "enhancing liquidity," but the irony is that all that evident liquidity was really just the flip side of ludicrous leverage piled up in casino Wall Street. That the dollar volume of bets in these exotica so far outstripped the value of the underlying credits says to me that it was almost all about gaming the system one way or another. The insurers and endowments and hedge funds that got sucked into those opaque "markets" likely would have been better off going to Vegas, where at least you know the odds.

I agree, but my thought is that everyone should play their own position, basically. The investment banks can create anything they want. That's what they do. And it's up to No. 1, the rating firms and maybe No. 2, the regulators (who were taking far too much of a *laissez faire* approach), to pass on this stuff before it goes out the door. But it was primarily the responsibility of the rating agencies. If they didn't understand it, then don't rate it. It's like, if you don't understand an investments, then don't invest in it. But I don't see the issue as trying to control the investment banks. They are going to come up with all this crazy stuff. And why not? It's their job to push the envelope and create the newest, latest and greatest financial structure. The adult supervision should be supplied by the agent who is assessing credit quality. And they failed miserably. The investment banks' job is to put all the pieces together, check the conditions and shove stuff out the door. It's not their core job, really, to assess whether their products fit within an investor's portfolio or whether they are sound. That task should be left primarily rating firms and maybe secondarily to the regulators.

Wait a minute. I'd argue that it isn't in investment banks' best interests to lard their clients' portfolios with toxic waste. Besides, what about the investors? They also have some responsibility to their own organizations (and to their clients) to do their homework. The buyers of all the toxic waste out there were supposedly sophisticated institutional investors of one stripe or another.

Well, some of the responsibility does lie with the buyers, too. They were just relying on what was given to them and should go beyond that. But to a certain extent I would also hope that the buyers could appoint agents who could and would represent their interests. In a lot of cases, institutional investors just don't have all the required expertise. Does it even make economic sense, if you want to distribute structured financial securities globally, to require each of the institutional investors do all of its own independent research? I don't think so. It would probably be a much more efficient process to have an agent represent buyers and have that agent do the due diligence and then stand in their clients' shoes to assess whether or not this stuff is any good.

Perhaps. I'm just wondering whether, from

the perspective of the whole cycle, there was any net economic benefit from all the billions that went into structured finance.
Well, in the current form, no. Not at all. Hopefully, in a new form, yes. Obviously, it distributes risk. The problem was there weren't any safeguards. The buyers weren't doing their jobs and were relying on parties that did not have their interests at heart.

I'm not sure distributing risk is always and everywhere a good thing. This crisis has driven home quite clearly that you can distribute risk all you want, but that doesn't eliminate it. Quite the contrary, if it's distributed too broadly, risk actually increases as everyone gets entirely too complacent.
I agree.

How else can anyone explain totally opaque private markets, with no clearing requirements, transacting billions and billions in transactions?
No trading information requirements, either.

How picky can you get? The dealers keep that under pretty tight wraps even in the plain vanilla bond market.
Right.This whole meltdown has driven home the fact that some significant safeguards are completely absent from the financial system. Now, let's hope, some safeguards will be put in place so that we can get the markets moving again. Something that strikes me as the oddest thing I've heard about in this whole mess, I heard while attending the Waxman Committee Hearings two or three weeks ago. Someone on the panel was questioning some guys who were with **S&P** and **Moody's** and one of the ratings agencies guys said, "We never did any spot-checking on the underlying mortgages because our attorney told us not to. It would increase our exposure." I thought, "Well, if you were doing a decent job of representing investors, why in the world *wouldn't* you do some spot-checking? Until the agencies start doing a decent job of representing their clients, you're going to continue to have these serial blow-ups.

Wonderful, since we're already in the midst of a very nasty recession.
I think you could argue that it's a depression. The definition of a depression is a 10% decline in GDP. Consider the fact that the consumer sector is 70% of the economy, and autos and home sales are the biggest portion of the consumer sector. Auto sales for the last month for GM were down 45%; for Ford, they were down 30%; Chrysler about the same. Meanwhile, home building is about half (at best) of where it was a year ago. Basically, we are in a depression right now.

Whose definition of a depression is that?
An economist's, I'm not sure which. I was taping an appearance on *60 Minutes* recently and they presented me with that definition. I had thought I'd approach the topic of the downturn in a different way, but they said, no this is the economists' definition of a depression.

All sustained downturns were "depressions" until after the Great Depression — which made economists and politicians alike eager to come up with a euphemism.
True. My point is really that, take the auto industry, with its high operating leverage and high financial leverage. For Detroit, a 5% sales decline is a killer but we're talking here about a 45% plunge. It is devastating. The home building industry has the same sort of dynamics.

Meanwhile, what people have seen coming out of lame duck Washington hasn't exactly been confidence-inspiring.
Oh, I agree. I get upset just thinking about the way the WaMu transaction was done, where they trashed the senior secured bondholders because the FDIC didn't have the cash to do a proper takeover. It's crazy. In the meantime, they increased the capital draws for all the other banks. They saved **Bear Stearns** but not Lehman Brothers? And **Goldman Sachs** and **Morgan Stanley** are allowed to go under banking charters? It's chaos.

Evidently, that's been the "plan." So what's your advice to the new team?
Relying on people like Paul Volcker is a good start, at least it's not the same cast of characters – or den of ...

Got it. Thanks, Sean.