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INSIDE

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listeningin

When "AAA" Isn't...

Sean Egan Surveys Likely Impact Of Downgrades On Monolines, Banks

Now that even a modicum of rationality has seeped back into the bond markets — though that's entirely too gentle an image, since what reason has returned has been brutally force-fed into the capital markets' collective consciousness via stark spectacles like gaping spreads and AWOL bids — it is, as ***Bill Gross*** *points out in an op-ed piece in this morning's* New York Times, *startling to see clearly just how absurd were the "verities" on which the late, great credit bubble depended. Like the alchemic ability of the banks, with a yeoman assist from pliant rating agencies and woefully undercapitalized bond insurers, to transmute the toxic waste thrown off by their structured finance labs into coveted "triple-A"-rated paper and to distribute same, worldwide. Now, of course, the great unwind is in (slow) motion, and it's altogether fitting that the erstwhile magicians are caught in its crosshairs. While lawmen hover, the rumor mill and headline writers alike are obsessing on the prospects of a bailout for the likes of MBIA and Ambac...because heaven forefend they have to turn their attention to the banks.*

No one, perhaps, is less surprised by this turn of events than ***Sean Egan****, who — with co-founder* ***Bruce Jones*** *— founded the cleverly named* ***Egan-Jones Rating Co.*** *in the early 1990s in the touchingly naive belief that institutional investors would flock to buy credit market research services from an outfit that doesn't depend on the issuers it's rating for its daily bread.*

Sean had pointed views on the developing mess — and ways to play it — when I first interviewed him in these pages 18 months ago, and intervening developments have not dulled his insights or his wit, which were on ample display when we spoke Monday.

KMW

How does it feel for your usually low-key business to be at the center of the

Ratings Discrepancies

	ACA	AMBAC	FGIC	MBIA	MGIC	Radian
"Pipeline Losses"	$12+B	$9.4B	$5.5B	$20.2B	$9.6B	$9.6B
Shareholders' Eq.	$326M	$2.3B	$2.5B	$6.5B	$4.0B	$3.4B
Market Cap	$28M	$1.2B	-	$1.8B	$1.4B	$657M
PLosses/Mkt. Cap	400:1	7.8:1	2:1	11:1	5.2:1	11:1
Recent Q Net Income	$-1.04B	$-3.2B	$69M	$-37M	$-372M	$-703M
Egan-Jones rating (sen debt)	C (neg watch)	BB-	-	B+	BB- (neg watch)	BB
S&P rating	CCC	AA	AA	AA	A-	A (neg outlook)
Moody's rating	Not rated	Aa2	Aa2	Aa2	A1 (neg watch)	A1 (neg watch)

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Victor Juhasz
Page 1 Illustration

maelstrom?
Unreal. Moody's just announced a big change in their rating system –

I was trying to decipher that announcement myself a few minutes ago.
I guess they didn't like their old system.

Do you suppose they think that there is, just perhaps, a problem with it? What was their first clue?
Exactly. Maybe after the fourth subpoena, they had an inkling.

Once again, I wish there were a way to go long the plaintiffs' bar.
You're not alone.

Have you figured out what sort of ratings changes they're proposing? The initial news item was pretty vague.
Well, they're actually looking for market participants to make suggestions. Funny, I thought that they knew their business and assumed that they wouldn't have to ask the market what they need to do. Our primary comment is that they're not addressing the major problem – which is that they are compensated by the issuers. If investors' interests are diametrically opposed to issuers' interests, they can change the rating system every other day if they want to – and it's not going to have any lasting effect.

Which is why you structured Egan-Jones to be supported by investors. Still, Moody's did toss out some ideas, didn't they, about how they'd change their ratings?
Yes. One was to use numbers, supposedly for ranking asset-backed securities, which is kind of odd because all the institutions that use their ratings are used to the letters and numbers, the A1, A2, whatever, that they've traditionally used. Other than increasing the administrative costs, I'm not quite sure if that would accomplish anything.

It would make it all the more difficult to compare ratings over time.
True. It reminds me of a story from when I was in business school 25 years ago: A departing CEO gave the new CEO a thick envelope and said, "If you get into any real trouble, open these three letters." The first one said, "Change the accounting system." The second one said, "Buy another company," and the third one read, "Prepare your resume." In this case, they're changing the equivalent of the accounting system.

> **"Monolines are scratching around for capital right now, and they don't look, act, smell or talk like triple-A rated credits. So they probably aren't triple-A rated credits and yet S&P and Moody's continue to carry them at triple-A."**

And this is a club that you fought for years to join? Congratulations, by the way, on the SEC finally granting your firm "Nationally Recognized Statistical Rating Organization" status, just in time for Christmas.
Yes, after 11 years, they couldn't stand all the phone calls anymore.

But it's not exactly the best of times to boast you're a bond-rating organization.
I know! That's why, when somebody says the rating firms are doing a terrible job, I say, please, use an adjective in front of a "rating firm." There is all the difference in the world between an *investor-supported* and an *issuer-supported* rating firm. I hope we're making a little bit of progress on that score, but most people do just say *all* rating firms are terrible. I take some comfort in the realization that Eskimos have about seven words for snow and we're only encouraging folks to use two words to distinguish among "rating firms."

Those other rating firms have suddenly become everyone's favorite whipping boys – and seem to well-deserve the abuse.
Exactly. Let's hope they do something in Washington to address this because when you have ratings going from triple-A down to D in

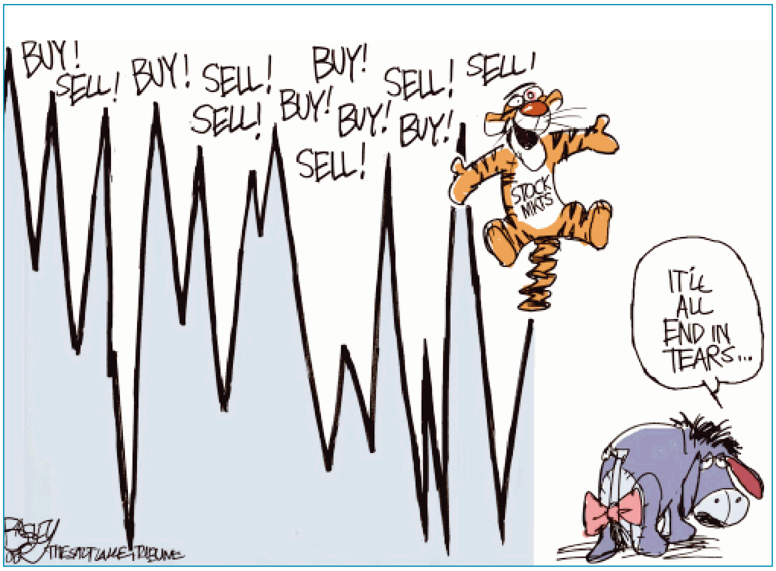
three days, which is what they did in several cases, it's a *huge* problem.

Three days? That was a fig leaf; Those were catch-up moves that probably should have happened overnight.
I think in some cases they did just slam them down in one day. In the case of the SIVs, I think they just completely forgot about matching assets and liabilities. They do it all the time. That's a key aspect when they're looking at banks, but they didn't think that the SIVs were really in that business. Well, guess what? *They are.* Actually, they're worse than banks. At least banks have some real equity in there, SIVs don't.

What an incredibly convoluted credit system we've allowed to evolve out there. Try explaining to most folks how some outsized risk-taking by a group "boring insurance companies" is threatening the solvency of the banking system. Yet Egan-Jones was very early to slash its ratings on the monolines –
Yes, and that's been – more than the topic *du jour* lately – it's been the topic *de la semaine*. **MBIA** (MBI) has traded down here again. The way we view it is that a "triple-A" is an issuer that can pay its obligations *come hell or high water*, like the U.S. government. If the U.S. government needs money, it can print it, or it can raise taxes, or both, actually. Whereas in the cases of monolines, they're scratching around for capital right now, and they don't look, act or smell or talk like triple-A rated credits. So they probably *aren't* triple-A rated credits and yet **S&P** and **Moody's** continue to carry them at triple-A.

You did a conference call last Monday [1/28] to explain why you are rating the monolines much lower than your rivals – even though they keep making threatening noises [and Moody's did move against XL Capital on Thursday (NewsBite, page 5)]. But my sense from the questions I heard addressed to you was that a lot of investors just couldn't believe what they were hearing.
Exactly.

Yet the haircuts you were applying to their assets seemed relatively modest, actually, compared to what has happened when a few banks have marked some mortgage assets to market.
I know! Yes, I think that our estimates of the



monolines' "pipeline losses" are going to be proven on the low side.

Let's run through why you don't place high odds on any rescue of the monolines–
Let me start by stressing that we have no financial interests in these firms – we only try to issue timely, accurate ratings and research – for which we are compensated by investors, not issuers. Let me admit, too, that it's hard to keep up with the rapidly evolving mortgage markets these days – even to keep up with the modestly negative moves our rivals are making to respond to the massive losses being reported by the monolines and their continuing inability to raise any significant new capital. But we try. More credit problems have also surfaced at **Merrill Lynch** (MER)and **Citigroup** (C), but I have to say that both of those companies have been at the forefront in dealing with the losses. Maybe because they both have new CEOs and because both also have enough market heft to raise additional capital with relative ease.

Even if they have to go to sovereign wealth funds to do it. You don't see the monolines treading that path?
We have been and remain bearish on the monoline credit and bond insurers; our median rating is seven or eight notches below those of the issuer-supported rating firms. [See table, page 1.] The main argument for a rescue of the monolines is that the top five investment banks –that is, Merrill, **Morgan Stanley** (MS), **Goldman Sachs** (GS), **Lehman** (LEH), and **Bear Stearns** (BSC) – have approximately $23 billion in exposure to the monolines; a rescue presumably

newsbite

MBIA to Sell $750 Million of Stock To Avert Downgrade

By Christine Richard

Feb. 7 (Bloomberg) -- MBIA Inc., the world's biggest bond insurer, plans to sell $750 million of stock in an effort to bolster capital and retain its AAA credit rating.

MBIA, based in Armonk, New York, said the private-equity firm Warburg Pincus will make up any shortfall in the sale by buying convertible participating stock. Warburg Pincus has already purchased about $500 million of MBIA shares.

Bond insurers led by MBIA and Ambac Assurance Corp. in New York need to bolster capital to avert downgrades that would cast doubt on the quality of $2.4 trillion of securities the industry guarantees. Fitch Ratings said this week it may cut MBIA's AAA insurance ranking, after lowering Ambac by two levels to AA last month because of mounting losses on subprime-related debt.

``The most significant fact is that they're raising the amount of capital from what they previously announced,'' Wilbur Ross, an investor in distressed companies, said in an interview with Bloomberg TV. ``I would be astonished if they hadn't consulted with the rating agencies before they made this announcement,'' he said, adding that MBIA may retain its AAA.

If the offering...is successful, MBIA will have raised about $2.25 billion since November...

The extra funds may not be enough to avert a downgrade because rating companies are increasing the capital they demand bond insurers set aside, Bank of America Corp. analysts led by Jeffrey Rosenberg wrote in a note yesterday.

``What we see is an almost day-to-day change in the rules of the game,'' said Donald Light, an insurance analyst at Boston consultancy Celent. ``At best we can say we're not sure'' if the capital will be enough three months or a year from now.''

would forestall any additional writeoffs by Wall Street firms. But this argument is offset by a few facts: Most of the investment banks are in the process of replenishing capital and are reluctant to make substantial commitments, the Wall Street firms' $23 billion of exposure is dwarfed by the monolines' $2.3 *trillion* of guarantees (therefore any contribution the Wall Street firms make is likely to be absorbed in covering other risks), the additional capital needed by the monolines to maintain top credit quality is far in excess of any amounts the Wall Street firms are capable of providing, and for all of its maneuverings and headlines, the New York State Insurance Department has few levers to encourage the banks' participation.

Might it not help if the investment banks were coerced into throwing at least a few billion into the pot?

An infusion by Wall Street firms of $5 billion to $10 billion dollars might delay the inevitable, but it would not be not be enough to substantially alter the monolines' plight. The other name bandied about as a possible rescuer is **Wilbur Ross**, who has a history saving steel, coal and textile firms. But we doubt that even Ross will be able to raise the massive amount of capital needed to save this industry. Besides, it's very possible that he could decide to invest directly in the business, as Warren Buffett is doing, instead of becoming encumbered by under-priced policies of most of the existing carriers. Although a plan could be cobbled together with parties such as **Christopher Flowers**, **Warburg Pincus** and others, the risk to such investors is high since falling short of a solid triple-A credit quality level probably imperils new business writing and pushes the firms into run-off mode. While they are sometimes also mentioned as white knights, **Fannie Mae** (FNM) and **Freddie Mac** (FRE) are now hobbled by low capital levels and pending portfolio charges. Delinquencies and defaults are rising and the share prices of most firms involved in the mortgage finance market remain under pressure, despite the rally we've seen lately.

You're really saying that the best they can hope for is some sort of arrangement to put them in run-off mode?

As far as I can see, the only party with the wherewithal to support most of the monolines is the federal government. But that sort of rescue, I think, would be a non-starter – especially in an election year. It would probably be perceived as a bailout of the securities firms that, in part, caused the problem in the first place. Only very rarely does the federal government get involved in providing direct support. For the Chrysler guarantees about 20 years ago, the justification was job creation. With the S&L industry, there was justification found in the federal government's oversight obligations. I just don't see that kind of justification for the monolines.

Especially because most people don't understand what got them into this fix in the first place.

It doesn't help that, unlike most credit stress events, the action in the monoline insurance firms is happening at the balance sheet level rather than cash flow level. The credit insurance they wrote on structured finance products normally provides protection for the payments on the underlying bonds. Cash flows might be reduced for several quarters before that would impact the senior tranches on which they wrote insurance and force them to make payouts, and even then the cash flow impact would be spread out over the lives of the securities. Then too, insurance companies have traditionally had some latitude to delay the recognition of losses. However, a properly adjusted balance sheet should rapidly show the adequacy of their capital deteriorating. Especially because accounting firms have become less docile post-Enron. They still remember having to pay massive fines and now have one less competitor to worry about. And "traders at risk," like the banks and brokers, are under considerable pressure to assess cashflows at market rates. Not to mention that year-end audits are likely to discourage the "mark to model" approach, particularly for banks and brokers. (FASB 157 Fair Value Measurements starts for fiscal years after Nov. 15, 2007 and for interim periods within those years and it emphasizes prices in active markets, giving the greatest weight to recent trades.)

Add it all up and you've estimated that a cool $200 billion would have to be pumped into the monolines at this point to keep their credit ratings legitimately at triple-A? How did you arrive at that nice round number?

This is not an exact science. We estimated that the major monolines have losses already in their pipelines of over $80 billion and so we multiplied that by about 3 to provide a cushion for a triple-A rating.

But are these "pipeline" losses real at this point, or more of an accounting identity?
The losses are real, but not yet realized (hence the term "pipeline" losses). The fact is that unless the mortgage market changes dramatically over the next 18 months, the monolines will be faced with having to make massive payments to support guarantees they've made.
Think of this ongoing balance sheet squeeze this way: If a monoline has $10 billion of structured finance assets and $90 billion of other assets against $93 billion in debt, it has $7 billion of book value. But if that same monoline has to writeoff 50% of those structured finance assets – while nothing else changes – it would see its shareholder's equity knocked down to $2 billion and it would most likely have to sell assets, cut its dividend, slow its growth and raise equity.

Okay, but isn't a 50% haircut on those structured finance assets pretty draconian?
It's very hard to know, but I don't think we're being unreasonable–and we're not applying 50% haircuts across the board. That was just a number to make the illustration easy. But there just aren't a lot of transactions being reported. Very few major firms are marking to market for securities valuations. **Thornburg Mortgage** (TMA) and Merrill probably came closest. Back in mid-August, when the market was much stronger than it is today, Thornburg sold very solid mortgages (with loans-to-values of 67%) at a 5% discount. More recently, in its fourth quarter, Merrill wrote down super senior "triple-A" CDO tranches by 19%, mezzanine super-senior "triple-A" CDO tranches by 37%, and super-senior "triple-A" CDO-squared tranches by 57%. And **Wachovia** (WB) just reported a 67% writedown on $1.23 billion of mezzanine structured finance.

So your estimates for the various monolines incorporate haircuts of varying sizes?
Exactly. For **ACA Capital**, for instance, we estimated pipeline losses at 20% on their $68 billion of insurance in force (as of the June 10Q) via ACA Financial Guaranty, which comes to $13.6 billion. But they also have retained equity of $174 million in delinquent CDOs, where we estimate the pipeline losses do run to 50%, or $87 million, and $141 million of mortgage backeds held as "available for sale" on which we figured the pipeline losses at 20%. When you add that up, you actually come to more than $14 billion, but for our estimate we wanted to be conservative and used just "greater than $12 billion.

What about Ambac?
There, we were able to use the September Q, which showed exposure via insurance in force on subprime and second CDOs of $26.9 billion, and we estimated its pipeline losses at 35%, or $9.4 billion. We expect Ambac will have difficulty raising sufficient additional capital and therefore might further cut our rating – which is already 12 notches below S&P and Moody's ratings.
For **Financial Guaranty Insurance Co.**(FGIC), total exposure to CDOs and mortgages via insurance in force comes to $55 billion, but we estimated pipeline losses at just 10%, or a "mere" $5.5 billion. Likewise at **MBIA**, exposure on CDOs and mortgages totaled $187 billion, and pipeline losses, estimated at 10%, came to $18.7 billion. But MBIA also has structured finance assets on its balance sheet, $8.7 billion of them as insurance assets and $6.2 billion as "investments held to maturity," and we figured that pipeline losses on those would total another $1.5 billion in round numbers. Frankly, a 10% haircut – or more precisely, a 10% best estimate of a blended rate for losses on the portfolio, net of any ceded insurance – is too low, given current market conditions. However, that loss of 10% translates into *5 times* MBIA's market capital and so makes it abundantly clear that it would have difficulty raising capital.

Didn't you also give MGIC and Radian basically 10% haircuts?
No. Their default and delinquency rates were starker, per their September Qs. **MGIC** reported, for instance, $14 billion of A-minus insurance exposure, of which 16.8% was delinquent. Some 26.8%, meanwhile, of its $5.8 billion of subprime exposure was delinquent at the end of the third quarter and 8.2% of the $28.5 billion of reduced documentation mortgage exposure on its books was also delinquent. We estimated, therefore, that it had pipeline losses of 20%, or $9.6 billion.
In the case of **Radian** (RDN), we happened to come up with the same figure for their estimated pipeline losses. But that was after applying a 20% haircut to $36.3 billion of Alt-A insurance exposure on which they're experiencing more than an 8% default rate, and to $5.8 billion of A-minus and below exposure on which defaults are running over 14%. Making things even stickier for Radian as house prices fall is that it insured $65 billion of mortgage securities with loans-to-values of over 95% and almost $9 billion more with loans-to-values between 90% and 95%.

newsbite

Security Capital's Bond Insurer Loses Aaa At Moody's

By Emma Moody

Feb. 7 (Bloomberg) -- Security Capital Assurance Ltd.'s bond insurance units, hobbled by a decline in subprime mortgage securities, lost their Aaa credit ratings at Moody's Investors Service.

XL Capital Assurance Inc. and XL Financial Assurance Ltd. were cut six levels to A3, New York-based Moody's said today in a statement. The outlook for both is negative, Moody's said. All securities guaranteed by the insurers will be downgraded to A3 unless they have higher underlying ratings, Moody's said.

The units of Hamilton, Bermuda-based SCA were stripped of their top rankings at Fitch Ratings last month after SCA decided against raising money to cover losses on subprime securities the businesses guaranteed. The downgrades throw into doubt ratings on as much as $154.2 billion of debt.

``SCA is more weakly positioned than many of its peers with respect to business franchise, prospective profitability and financial flexibility,'' Moody's said in the statement.

The company has claims paying resources of about $3.6 billion and needs more than $6 billion of capital to maintain an Aaa credit rating, Moody's said.

SCA closed down 17 cents, or 6.1 percent, at $2.60 in New York Stock Exchange composite trading. The shares have lost 92 percent of their market value in the past year...

Credit-default swaps tied to XL Capital Assurance rose 50 basis points to 13 percent upfront and 500 basis points a year, according to Credit Derivatives Research LLC. That means it would cost $1.3 million upfront and $500,000 a year to protect $10 million of debt for five years.

If the situation is as grim as all that, how can S&P and Moody's justify not slashing the monoline's ratings, too?
Our view is that the major rating firms *will* cut their ratings on monoline firms as their problems become even more obvious – probably via multi-step downgrades as capital raising efforts fall short. From our perspective, the argument that most structured finance and mortgage bonds and swaps are trading at depressed levels because of illiquidity is rapidly being debunked. Those securities are trading at weak levels because losses are already "baked in" and will manifest themselves within the next couple of years.

"This is about the Fed doing everything it possibly can to shore up the capital of the major financial institutions."

So the slow-mo train wreck is continuing. And I take it that you don't think it's been fully discounted in the market?
We have our doubts. **Ambac** (ABK) has concluded that it doesn't want to raise additional capital. It has said that a bailout, if it does happen, will only address the municipal side of its business. And that really doesn't help the bondholders of Ambac, nor does it help the stockholders. That's the side of their business that carries relatively low risk. And the sad reality is that its pipeline losses are significantly greater than its market cap.

What's more, had the monolines' stuck to their original business — instead of insuring all sorts of derivatives to the tune of many times their equity bases — they wouldn't be in this soup.
They'd be in terrific shape, yes. The irony is, as **Charlie Gasparino** has reported on *CNBC*, some of the monolines entered the structured finance area *at the request* of S&P and Moody's, who said that they needed more diversified revenue sources. Isn't that fascinating?

Very, considering that S&P and Moody's needed someone to offer that insurance cover so that they could slap triple-A lipstick on the all structured finance paper they were rating for the investment banks.
Exactly. The firms behind the curtain happened to be S&P and Moody's.

Will we ever get to the bottom of who paid whom for what?
No, I don't think so. I don't see anyone rushing to the forefront to clean up this industry.

Yet as we started out noting, even S&P and Moody's are moving towards admissions that their rating systems need an overhaul.
Yes, they're scratching their heads trying to figure out what to do – while still hoping that all this just goes away. Which is why, when we say that MBIA and Ambac are not triple-A, they say that we're crazy. Time will tell. We've been bearish on both those companies for quite some time. The equity side is coming around to our view and sooner or later, the debt side will, also. In fact, the debt side already has, if you look at spreads and things like that. MBIA has been paying very high rates to attract fresh capital [Wednesday it unveiled plans to raise an additional $750 million in capital through the sale of common stock, backstopped by Warburg Pincus pledging to make up any shortfall by purchasing as much as $750 million in convertible participating preferred]. That doesn't sound like a triple-A credit to me.

Or me. Our last interview [June 30, 2006] about ratings insanity was just about six months too early. The markets didn't even start smelling the credit unraveling until last February. And there's still a fair amount of disbelief. Why, do you suppose?
I think this crisis in the mortgage and structured finance area is bigger than anything the markets have seen, both on an absolute and on a proportionate basis. The **S&L crisis** and **Enron** and **WorldCom** were nothing compared to what we're in the process of experiencing now.

***"Nothing?"* So much for a contained crisis.**
I like what **Jim Grant** said, "Yes, it's contained. It's contained to the planet Earth." Never in my 25-26 year career have I ever seen a case where the **Federal Reserve** has cut interest rates 125 basis points in a four-day period.

That *was* rather eye-opening.
Especially because we're not talking about cutting them from a base of 15%! This is about the Fed doing everything it possibly can to shore up the capital of the major financial institutions. It's not as though oil prices have been halved or that food is going down in price. All the major expenditures that people have to make have been going up in price and going up substantially. The only reason for the Fed to be making these major cuts is to shore up the financial sector. Its actions speak much louder than any words that **Hank Paulson** – or anybody in the Fed or Treasury – is voicing right now.

Actually, its rate moves pale against what

the Fed has been doing with its new "Temporary Auction Facility."
Right. Every single lever that they can think of, they've been pulling. And they've been getting some support in Europe. Yet the markets haven't made much progress. What is going on is that they're trying to do everything they can to help out the commercial and investment banks – to offset the flood/tsunami of additional major writedowns that's on the horizon. The most important business to investment bankers has been the mortgage securitization sector.

We've already seen eye-popping write downs at the major banks and brokers because of mortgage woes, but you're saying those were just down payments?
There are more to come. The monolines are critical. They're a linchpin in this whole process, and the reason relatively straightforward. When a bank treats a security as triple-A (because it carries insurance from a triple-A rated monoline), the amount of capital that bank is required to hold to back that security is minimal. However, if that security's rating goes down to double-A or single-A or triple-B, the bank's capital requirement rises –

By a lot. You're talking about the banks' so-called Basel II capital requirements, which make it much more expensive for banks to hold lowly rated assets. Not to mention to hold ones that no one can figure out how to value.
Right. And these standards apply not just in the U.S., they are worldwide. So the financial sector worldwide is trying to grapple with this. Cutting short rates to steepen the yield curve (and bolster banks' net interest margins) helps some, but there's not much more room to cut most rates, unfortunately. Another way to solve this problem is for the banks to shrink their balance sheets, but that is not in the politicians' interests.

Instead, bank balance sheets have been ballooning lately — but not because of anything likely to encourage economic growth. Putting SIVs back on bank balance sheets doesn't expand outstanding credit one iota.
Exactly, as those "assets" have come in the door, there hasn't been any equity accompanying them. And any new equity they have been able to attract has come only at a very high price. Citigroup is exhibit A on that score.

Its new sovereign wealth fund investors are getting pretty sweet deals while its existing shareholders get only dilution.
And the fear is that, as they take additional writedowns, the next dollar of capital that comes in the door will be even more expensive.

Yet at least some investors rushed to buy Citi as the market rallied in late January. "Too cheap; too big to fail" and all that.
Citigroup is now at $29, up from as low as $22. But it was $47 or so last October. It might well be too big to fail. We don't argue with that notion. Citigroup will probably be stabilized over the next quarter or so. The problem is that it's going to take *time* for them to work through their difficulties. And that goes not just for Citigroup, but for many of the other commercial and investment banks. It will take *time* for them to work through their problems.

Time is the one asset that most investors aren't terribly willing to risk.
Exactly right. Think about how long it took to work through the S&L crisis.

A good point. And that mess was contained to just one part of the U.S. financial sector.
What's interesting about the S&L crisis is that the federal government got directly involved by setting up the Resolution Trust Corp. to buy the S&L's bad assets. But right now there is no nexus for the federal government to get involved in the monolines. The monolines are all regulated, such as they are, by the various states. The reason, in our opinion, that **Countrywide** (CFC), was bailed out was because the *federal* regulators essentially told **Bank of America** (BAC) to do it. The FDIC in particular didn't want to see $40 billion of insured deposits in Countrywide's savings bank unit placed at risk. So who knows what side deals were cut there. But you can be sure that the federal regulators were very involved.

Now, the monolines' problems are also the banks' problems, as I understand it, because the banks are holding so much of the dicey paper they've insured?
The real issue is that if the monolines' ratings are downgraded, the banks will have to take major writedowns on insured assets that they're holding – that they then would no longer be able to consider triple-A assets.

And "major" writedowns in this instance would total about what?
We've seen the figure put at about $30 billion. There would still be some underlying value in those securities, but it's tough to work through the exact amount because the level of disclosure isn't there. Maybe it will be, once we see new 10K filings for the major financial institutions, but that could be a while. We haven't done any independent work to come up with a number because the information just isn't available. What's clear is that it would be a major hit and would put pressure on any new business activities of the banks. They're less likely to lend new money if they're struggling to rebuild capital. Especially because the multiplier is huge. If you take away a dollar of equity from the big banks, you have to subtract about $12 of assets.

Yet the markets are actually treating this morning's news that a Fed lending survey shows bankers starting to pull in their horns as *news*. Hello?
Exactly. They have to do that. For two reasons: Lending standards are tightening up because everybody is double guessing credit decisions. Two, many of the financial institutions don't have the equity they used to. I'll add a third reason, too. Their cost of equity capital has risen dramatically as the perceived risk has increased. And the steepening of the yield curve hasn't fully offset the perceived increase in risk, either.

So what happens next? My observation is that any other time I've seen things look this grim in the financial markets, something has happened to, in effect, change the rules.
Exactly. I think that you're going to experience that in this case too. I think you're likely to see a some sort of bailout cobbled together of the *municipal portions* of the monolines. Why? Because that business is near and dear to the government's heart. You're going to see a huge amount of support for that. Even if that doesn't happen, the muni market in general has historically had low default rates and so the loss of credit insurance shouldn't significantly hurt credit quality. And, since spreads have gapped out, there are probably opportunities there *on the long side.*

Imagine that. But even if there's a bailout, if I'm the city of Oshkosh, who am I going to pay to insure my new bonds, one of the bailed-out monolines or that company set up by that new fellow, Buffett?
You're likely to go to Warren's new company because he has a true triple-A. Absolutely.

So all a bailout on the muni side would do is turn the legacy monolines into zombies until their existing books are runoff?
You're asking what good would a bailout do? I think it would put a stop to these failed auctions of municipals. It would help there. I think it would prevent a run out of insured muni paper on the part of the the mutual fund industry – many funds have clauses written into their investment guidelines dictating that they can only hold investment-grade securities. A bailout of the muni sides of monolines would mean that those mutual funds wouldn't have to blow out all of the insured muni bonds that would otherwise lose their ratings. A bailout would provide a fig leaf of protection – an excuse – for S&P and Moody's not to cut their ratings in the municipal area for those securities that were backed by Ambac and MBIA. Those are big positives. But I think you would still see any new insurance gravitate to Warren Buffett, provided that the premiums he is charging aren't significantly higher than those charged by any successors to MBIA and Ambac.

What about the structured finance sides of the monolines?
There, you're probably going to see an increasing realization that a bailout plan is unworkable. I don't think it's possible to bail out the non-municipal portions of the monolines. In fact, we've have a prelude of that with ACA's difficulty. They were cut from single-A down to triple-C by S&P and for two months now, I think, they've been trying to work out a bailout plan. The day of reckoning keeps getting delayed, but that won't last forever.

Then what?
What I suspect wouldn't be unreasonable to happen when the situation gets serious enough – when the likes of Ambac and MBIA lose their investment-grade ratings – is that the federal government will have to step in with some sort of emergency capital, not for the monolines, but *for the banks*. But that's not going to happen right away, because it's in everybody's interest to hold off. It's in the investment banks' interest, in the commercial banks', in the issuer-supported rating firms' interests, and in the government's interest, to hold off any negative action on the monoline insurance

companies. But that is not going to stop the train wreck. It's just going to slow it down.

In other words, the major banks are too big to fail, but not the monolines?
Sure. That's a much more workable plan than trying to bailout the monolines. In the case of the commercial and investment banks, there's a more direct link between the benefit and the money expended. For every dollar that you contribute to the monolines, it might be that only 30-40 cents would end up benefiting U.S. investors, and of that, only a small portion would benefits banks. So if the federal government is going to restructure anything, they're better off focusing directly to the investment and commercial banks. Or at least the commercial banks. Who knows about the investment banks? After all, the monolines have exposures to structured finance in the $2 trillion or $3 trillion area, in total, while we're only talking about exposures for the commercial banks of about $30 billion or $40 billion. So if you want to save anybody, you're better off saving those entities that are near and dear to the federal government's heart, which happen to be the U.S. commercial banks. It's doable. The federal government could say, "Okay, Citigroup, we're going to give you $5 billion. We'll structure it in the form of special preferred stock. You pay 5%." If we did that for five commercial banks, the tab would run $25 billion. From a public policy standpoint, you should put your money where it's going to have the biggest impact, at the lowest cost, and that's going directly to the commercial banks.

And you expect Congress would go along?
Sure. How long did it take the House to pass the $150 billion special stimulus bill? What was it, about a week or so?

Yes, but the Senate isn't being as pliable.
Right, but I think it would happen very quickly if it came to that. We're not quite there yet.

The big brokers, you've mentioned, are also heavily exposed to losses if the monolines are stripped of their triple-A patina—
Our major concerns there are with Bear Stearns and Lehman. Bear Stearns is one of the biggest players in the mortgage finance area, but it has not provided anywhere close to the level of disclosures needed to responsibly analyze its situation. We hope that's going to change. But mortgage finance was much greater part of their business than it was at any other investment bank. It was huge. And Bear doesn't have a lot of other business areas to offset any decline, unlike all the other investment banks. Their asset management group isn't as large. Their investment banking effort isn't as large as the others'. But the issue that really concerns us is the valuation of Bear's mortgage and mortgage-backed assets. A charge comparable to the one taken by Merrill would wipe out a significant portion of the firm's $13 billion of shareholders' equity. The market has been assuming, you know, that there's essentially a put out there on Bear Stearns – either a non-U.S. buyer or maybe a Bank of America. But that assumption might be tested over the next six months.

> **"You might argue that the government may need a sacrificial lamb to argue that they've cleaned up the sector."**

You're suggesting —
I think the certainty of that put is not as great as it was probably 6 or certainly 12 months ago. In fact, with all the investigations swirling around it, you might argue that the government may need a sacrificial lamb to argue that they've cleaned up the sector.

Especially if they have to pump money into the banks?
Right. And look at Countrywide. That stock dropped what, 85%, before Bank of America stepped in. We'll see if Bear Stearns is in the same type of situation.

What About Lehman?
With Lehman the issue is the valuation of its $88 billion of mortgage assets. There are three pages in its August10Q explaining how these assets, with no market prices, are being valued – as level II and level III assets. Again, if Lehman were to take a charge comparable to the one Merrill took, a significant portion of its $21.7 billion of shareholder equity would be vaporized.

And you also have qualms, I believe, about E*TRADE?
Let's just say it's no surprise that **E*TRADE** (ETFC) is reportedly in merger talks with **TD AmeriTrade** (AMTD). Or that the largest impediment to a deal is the charges ETFC will have to take on its mortgage portfolio. A 10% charge against its $43 billion loan portfolio will wipe out its $2.5 billion shareholder equity. Not to mention that its low credit quality will make it more difficult for other institutional parties to do business with E*TRADE.

What comes through time and again is

that nobody must have been paying any attention to the exposures they were running up in all this.
Well, it's because these securities never should have been placed in the market. That was the handiwork of S&P and Moody's, letting this gobbledygook come off the assembly line. They are supposed to be in there checking. That was – in our opinion – one of the core problems. If they say it's investment grade, they get paid a million dollars, and if it goes bad, they always have the freedom of speech defense.

Sounds like a great business model to me.
Oh, it's terrific.

To be fair, when even the chairman of the Federal Reserve Bank was saying that these derivatives were the greatest thing since sliced bread, why should the issuer-paid ratings companies have done anything differently?
Well, in the case of CDOs, you at least have a fighting chance of assessing the cash flows for the underlying securities. But in the case of a CDO squared or worse, you have no chance. Therefore they were, in our opinion, tainted products. They were flawed products from the get-go, that never should have been rated.

Didn't they make those ratings on the assumption that each tranche or whatever was stuffed with securities worth well more than face value?
Yes, yes. Extra value was put into the pot, and so it was safe, and on down the line. It was perfectly possible to construct rationalizations all along the line. But in retrospect you find that those assumptions and rationalizations didn't meet the test of time. So we go back to the importance of the alignment between the interests of the investor and the interests of the rating firm. If you don't have the alignment, then it's just a matter of time before problems arise. Our view is that S&P and Moody's, over time, will be seen by institutional investors for what they are. That is, akin to advertising agencies for the various issuers. So their representations and assessments shouldn't be the basis for investment decisions, any more than a glossy marketing brochure should be the primary source of a decision to buy a Ford or GM product. Some reliability data ought to be thrown in, at the very least. History has shown that the big ratings firms either cannot or will not take action when it's most important. They capped Enron at investment grade, because they were afraid that doing otherwise would hurt Enron's business. They're keeping MBIA and Ambac at triple-A because they're afraid that a downgrade would hurt MBIA and Ambac's businesses. That's exactly the wrong motivation for somebody who's supposed to be assessing credit quality for fiduciaries. And the sooner our fiduciaries figure that out, the better off we will all be.

Right — and *especially* Egan-Jones.
Yes, but there are plenty of other credit rating firms out there. There are about 80 rating firms worldwide, and if you include credit research firms, you probably bring the total up to 150. Think about this: We really have no conceptual problem with structured finance. Packaging things, dividing up the risk, that makes perfect sense. The problem has been on the credit evaluation side. There haven't been proper assessments of true credit quality. As somebody once said to me, "You know, there are no bad bonds. There are only a misrated and mispriced bonds." That's absolutely correct. In structured finance, the core problem has been a misrating of credit. On the monoline side, they poorly judged the underlying risk and did not price it properly. If they had priced it properly, it'd be no problem. They could have brought in a lot more reinsurance and offloaded the problems. The issue is that there wasn't enough room in their prices for them to afford to bring in let's say Warren Buffett as a reinsurer, or let's say AIG. And the issuer-paid rating firms facilitated that mispricing. In effect, they've allowed tainted meat out into the system, and so no one wants to buy any meat right now.

That's visceral enough for me. Thanks, Sean.