



**The Doldrums:
Thoughts on the Bailouts & Other Government Mischief**

All in a hot and copper sky,
The bloody sun, at noon,
Right up above the mast did stand,
No bigger than the moon.

Day after day, day after day,
We stuck, nor breath nor motion;
As idle as a painted ship
Upon a painted ocean.

Water, water, everywhere,
And all the boards did shrink;
Water, water, everywhere,
Nor any drop to drink.

--Samuel Taylor Coleridge
The Rime of the Ancient Mariner

The U.S. equity market remains challenging, with pundits and so-called experts forming two camps. One opines that the markets have bottomed and are recovering, the other that we are in dire circumstances and that there will be no meaningful recovery on the horizon for as far as the eye can see. We find ourselves as investors like Coleridge's Ancient Mariner after having killed the Albatross, in the doldrums, a condition where there is no discernible or foreseeable wind that will support us and lead us to our destination. We are awash in liquidity. Bank deposits have gone through the roof, the money supply is on a moon shot, and the Federal Reserve's balance sheet has never been larger. Interest rates are at multigenerational lows with the Fed having reduced the Fed Funds rate to a previously unfathomable 0.25%. Just when you thought that the Fed could do no more, it announced a week and one-half ago a program to buy \$300 billion of Treasury bonds in the open market to bolster liquidity further. The chattering political class has identified commercial banks as public enemy number one, droning on that they are hoarding the TARP money that the Fed provided them rather than lending it out. We find us like the mariner and his crew, surrounded by water, but none that we can use to drink. This does not appear to be true. Blaming him for their misfortune the crew tied the Ancient

Mariner to the mast and, as he told it, "Instead of the cross, the Albatross about my neck was hung." With the market dropping sharply nearly every time he speaks before congress and now being pilloried even by the mainstream media, one has to wonder if Treasury Secretary Geithner feels himself to be in the role of the Ancient Mariner, with the Troubled Asset Relief Plan (TARP) and other government bailouts constituting the albatross that he must bear. If it would be any consolation to Secretary Geithner, we would offer that it was the Ancient Mariner who survived in Coleridge's poem to tell the tale of woe.

As a general proposition, we are generally opposed to government intervention in the economic lives of its citizens. Despite the Congress decrying corporate greed and excessive risk taking, our government played a significant role in the current crisis. Conferring a quasi-governmental status on Fannie Mae and Freddie Mac without adequate oversight and the Community Reinvestment Act certainly contributed to the housing crisis. The SEC's elimination of the up-tick rule in July 2007 permitted rampant, and often illegal, naked short-selling and failing to regulate credit default swaps as insurance contracts led to the runs-on-the-bank that effectively brought about the demise or forced mergers of Bear Stearns, Lehman Brothers, and Merrill Lynch. These factors, combined with the ill-conceived stringent application of mark-to-market accounting rules that came with FAS 157 last year, drove the credit markets to lock up tightly, both in the U.S. and around the globe.

With all that being said, the TARP was well conceived as far as government bailouts go. The original concept was that the Treasury would buy distressed fixed income securities from banks at a significant discount to par and their real economic value. This would provide needed liquidity to troubled banks, establish an orderly market for the underlying securities, and the government could even make money as the asset values recovered over time. It seemed a pretty good deal for all involved. \$700 billion is a lot of money, but the original plan seemed to make sense. Then came November 14th when CNBC's Erin Burnett interviewed Treasury Secretary Paulson on-air. In responding to a question about why the TARP strategy had moved from buying troubled assets to one of making capital investments in banks, Secretary Paulson responded that things had been worse than originally thought and were continuing to deteriorate. The Treasury chose to make direct investments in banks as a quicker way to shore up their capital and get them lending again. The market which had been up all day immediately dropped and the S&P 500 Index declined by 4.2% that day following the Treasury Secretary's interview.

The allure of the TARP was seductive. We soon had liquidity strapped life insurance companies buying small commercial banks so that they could take advantage of cheap federal capital. The Treasury made its first TARP injections of \$125 billion into twelve large banks. Goldman Sachs and Morgan Stanley were either coerced or cajoled into reforming as bank holding companies and participating. The Treasury wanted broad participation among the largest banks to build market confidence by showing their commitment to maintaining the health of the banking system. Moreover, they wanted to avoid doling out capital purely on an as needed basis, lest people forge the connection that those who applied were most in need, engendering further bear raids by short sellers and runs-on-the-bank.

The primary failing of the TARP was that it has left unresolved the removal of so-called "toxic" assets from financial institutions balance sheets. While undoubtedly some of the putative assets may qualify as first-rate refuse, it is our contention that the amount and putridity of them is most likely overstated. One hears that people have lost faith in the banking system, yet we must reconcile that with the fact that bank deposits grew by \$370 billion in the fourth quarter of last year alone, despite the fact that the interest rate credited to those deposits was one-half of what it was a year ago. The twenty-four hour business news cycle focuses us on "toxic" assets threatening to blow up every bank, while 98% of all bank loans remain current with their scheduled payments. The primary issue seems to us to be one of price discovery. We have on the one hand a group of capital constrained financial institutions seeking both to deleverage and restore their capital base. On the other hand we have prospective investors, seeking to buy fixed income assets on the cheap and earn above market returns. The gains from trade would seem to be enormous for both sides and a suitable market-clearing price should emerge. It should also be noted that the current method of distributing TARP funds stands to be a reasonably profitable venture for the Treasury, provided that the recipient banks are able to pay them back. Most of the preferred shares that the government has taken in exchange for capital injections pay a 5% annual dividend for five years and 9% thereafter, if the funds have not been repaid. Further, the government also received warrants to purchase common stock in the banks, so that they will make money should the underlying shares recover to suitable levels.

The TARP funds have not come without strings. We have seen the recent uproar over Merrill Lynch and AIG bonuses. This has prompted the Congress to put forward a 90% tax on bonuses paid to employees of institutions who have received bailout money with the Administration's tacit approval. Northern Trust became an object of Congressional derision when they dared to spend money to

entertain clients as part of their sponsorship of a professional golf tournament in Los Angeles. Northern Trust has joined TCF Financial, Goldman Sachs, Iberia Bank, Signature Bank, Sun Bancorp, and Bank of Marin Bancorp in notifying the Treasury of their intention to repay the TARP funds as early as possible. This is easier said than done, however. The preferred shares issued to the Treasury generally have three-year call protection, so the recipient banks must apply to the Treasury to repay the funds. This of course defeats the Treasury's objective of seeking not to stigmatize the recipient banks. It is apparently the government's version of the "and all shall have prizes" mentality that has entered many of our nation's youth athletics programs. Further, if compensation is to be capped in any manner it becomes obvious that those who can shed the burdens imposed by the government as a condition of having received the funds will gain from returning the money at the earliest possible moment, as they will gain an advantage in competing for talent. Once again, pursuing the politics of envy proves to have ugly, unintended consequences.

Beyond the TARP we have had programs to support the commercial paper market, asset backed securities markets, and the auto industry among others. By our count we have now had bailout/industry support commitments by the United States government in excess of \$1.7 trillion. At the President's behest, the Congress has passed a \$787 billion spending bill under the guise of a stimulus package. The sad fact is that by the time the spending occurs later this year the recession will most likely be over or in the process of ending. The net effect is that our spendthrift Congress will attempt to maintain a ghastly level of spending for years to come, ballooning our national debt and raising the specter of high inflation. As we saw the estimates of the stimulus package (officially known as the American Recovery and Reinvestment Act of 2009) explode to over \$800 billion while the bill was being put together, the Congress brought it in at a stingy \$787 billion, as if to try to convince the taxpayers that they are good stewards of the national purse.

What is the next step?

The Treasury's objective in all of the bailout and facilitation programs has been to restore the banking system and credit markets to functioning health. They have been reasonably successful, or at least as successful as one has a right to expect. Banks have begun lending. Several asset-backed issues have come to the market successfully over the past few weeks with the benefit of the TALF Program. The first quarter of 2009 will see the highest level of worldwide corporate bond issuance on record, with corporations bringing \$294 billion in

bonds to market. Creating a means for removing impaired assets from bank balance sheets remains an issue. To that end, Secretary Geithner has a program to mix government with private money to create the liquidity necessary to foster the exchange of these assets. The equity market cheered the news as the S&P 500 Index rose by 7.1% and the KBW Bank Index rose by 18.6% the day he announced his plan. The word has now come down that the FASB will relax the mark to market rules to make them more representative of the economic reality of their cash flows, as opposed to marking them down to the last distress sale that some troubled institution was forced to accept. This should have the net effect of improving earnings and helping the beleaguered banks restore their balance sheets. More importantly, it should give them the confidence to increase their lending, thereby improving the supply of available credit in the economy. The early indications are that firms seeking to purchase securities under the Secretary's plan will need to meet substantial capital requirements, which should restrict participation in the plan to a handful of large money management firms and investment banks. These firms may then turn around and resell the securities, thus it is that we will see the market for these securities begin to function again.

Do not expect Secretary Geithner's plan to come off without its share of hiccups. There are likely to be large gaps between the last price at which the securities traded and the price where their current cash flows suggest they should trade. We would expect the cash flow price to be higher once the fire sale price penalty has been removed. In a market of relational exchange where partners expect to trade with one another regularly over time price discovery comes relatively easily, and there is little incentive to gouge your trading partner in any one trade because that would likely keep them from trading with you in the future. As this process starts, we suspect that the approach will be more like one would see in a single or finite period of trading, where there can be large gains available to one party to the trade at the expense of the other. The problem arises from the relaxation of the simplifying assumption of microeconomics that all participants have perfect information. The process will most likely be marked by what economists call impacted information, where one party has superior information than the other and is in a position to extract a gain as a result. To understand impacted information, think of the 1941 screen adaptation of Dashiell Hammett's The Maltese Falcon. At the end of the movie the gang of thieves realizes that the statuette that they have stolen from a Russian general is not the jewel encrusted gold bird given in tribute by the Knights of Malta to the King of Spain, but a lead fake covered in black enamel paint. Joel Cairo (played by Peter Lorre) explodes at the portly Kaspar Gutman (played by Sydney Greenstreet) and blurts out words to the effect "You bloated idiot! With your foolish attempt to buy it,

it's no wonder that we had such an easy time stealing it." Greenstreet's attempt to buy the falcon tipped off their counter party that it might be more valuable than he originally thought, and he replaced it with a fake, which they subsequently stole. These things can happen in a one period exchange where not all parties know exactly what it is they are trading.

The Strange Case of AIG

By far the most difficult case of a government bailout to understand is that of AIG. To date the government has put some \$173 billion into the company in a combination of loans and direct investments. To appreciate the magnitude of that consider the absurdity that were the government to have made that as an equity investment, it would imply that AIG stock should be worth \$64.09 per share. The shares currently trade at \$1.07 each – quite a disparity.

Most recently our elected officials have become apoplectic about AIG having paid performance bonuses of some \$165 million to selected employees. We have seen the

House of Representatives pass an ill-conceived bill that would levy a 90% tax on the bonuses of any employee working for a company receiving more than \$5 billion in bailout money from the government. The bill stinks out loud from its conception. Even House Ways and Means Committee Chairman Charlie Rangel's first response was that it is bad policy to use the tax code as a political weapon to single out groups of people for disparate and unfair treatment. Yet, within days he underwent an apostasy and supported the bill, succumbing to a wave of public furor against the AIG bonuses. The Administration and the Congress were later embarrassed when it became public knowledge that Secretary Geithner and Senator Dodd had been involved with and approved the AIG bonus plan. Moreover, provision for the bonuses was written into the bill they passed, had they only bothered to read it. I would refer all involved to Article I, Section 9 of the U.S. Constitution, which prohibits the Congress from passing bills of attainder and *ex post facto* laws. A bill of attainder is a bill that calls specifically for someone's incarceration or the confiscation of his or her property. An *ex post facto* law is one that criminalizes or prohibits an action after the fact and seeks to punish people for actions taken prior to its passage. The bill would also seem to violate the takings and due process clauses of the Constitution. Some serious Constitutional scholars still have doubts as to whether the Supreme Court would strike the bill down. That scarcely matters. Whether or not the bill is unconstitutional, it is certainly unconscionable. Whatever one might think about the concept of a company receiving \$173 billion in federal aid paying bonuses to its employees, it is unseemly for the our elected representatives to be

grandstanding over in issue in which they were complicit rather than tending to the people's business.

AIG was brought down, of course, mainly by writing credit default swaps in its Financial Products group. It was easy for AIG to write this business. With their AAA credit rating they seldom had to put up collateral and they did not reserve against potential losses. The problem was that hedge funds and other investors used these swaps to speculate on various companies' credit, without owning the underlying bonds. These so-called "naked swaps" could be used more perniciously by bidding up the price of the swaps giving the impression that the underlying securities were plummeting in value. You could then profit by shorting the stocks of the financial institutions that would have to write down the value of the covered securities (mark-to-market accounting again), causing their shares to drop. In his October 7, 2008 testimony on the AIG bailout before the House Committee on Oversight and Government Reform, New York State Insurance Department Superintendent Eric Dinallo stated:

"What New York State is doing fits our role as insurance regulators. We are providing an appropriate way for those with an insurable interest to protect themselves. Our goal is to ensure the terms of the credit default swaps are written as a mechanism for protecting buyers against actual losses and not for betting on the credit quality of a third-party. We will also ensure that whoever sells protection is solvent, in other words, can actually pay the claims. There is currently no such protection for parties to credit default swaps that use them as insurance.

However, we are not and cannot regulate "naked" credit default swaps, which are used by speculators in the financial markets to profit on the downturn in a company's financial condition."

The concept of insurable interest is an important one. A party to an insurance contract must have a legitimate interest in the event that is being insured against. In the property casualty realm, I can not take out a policy on a building that you own on which I would profit by its burning down. In the realm of life insurance, I cannot take out a policy on someone's life with whom I do not have a familial, business, or some other valid relationship, hoping to profit should they meet their demise. Here we have the New York State Insurance Superintendent allowing the largest insurance company in his state effectively to underwrite insurance for people who do not have an insurable interest in the event that they are seeking to insure. Further, while he professes an interest in protecting

parties that hold both the underlying debt and the credit default swaps, he falls short of the mark. The commonly quoted statistic is that eighty percent plus of all credit default swaps are naked swaps. That is, people purchased them as speculation without an insurable interest in the actual debt. If you permit the writer of the insurance or swap (AIG for example) to blow themselves up by writing naked swaps (in some cases in an amount greater than the amount of debt outstanding for the swapped security), how is it that you are protecting the interests of those who bought them properly as insurance? That seems strange indeed. The alternative to an insurance treatment for credit default swaps would be to permit naked swaps but force the counterparties to meet strict capital and margin requirements to demonstrate their ability to honor their commitments. The latter route seems to be the one in which the regulators will be likely to go, as we do not have a national system of insurance regulation.

One final point on AIG needs to be made. The original markup of the bill to provide bailout funds to AIG was three pages long. By the time the bill passed it had grown to about 150 pages and provided funding for things that had nothing to do with AIG that were included as inducements to secure the votes necessary for passage. For example, the bill contained a provision to require health insurance plans to provide a parity of benefits between mental health issues and physical illnesses. What that has to do with bailing out AIG, I have no idea. It does, however, highlight the danger of using government bailouts rather than the bankruptcy code to assist and reorganize troubled companies. Once you exit the realm of the legal system in favor of the political system, the process becomes open to politics with all of the attendant problems that come with it. It is politics and government bureaucracy that will drive up the costs and reduce the putative benefits that any of the bailout programs ever offered. Thus, it is that we find ourselves like the Ancient Mariner and his crew in the doldrums. As any sailor can tell you, no manmade force will get you out; changing weather patterns will eventually supply the requisite wind. In the present case, government policy has certainly contributed to our problems and we would do well to wait for market forces to move us toward a new equilibrium. Ultimately, it will be the gains from trade available to willing trading partners that is likely provide the tailwind that we need.

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