

Market Update – April 26, 2009

This week's Market Update contains my thoughts on the following stories:

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If you are not able to sign up for my list through the Constant Contact email (some of you don't receive this, so it's impossible), send me an email at sandy.leeds@mcombs.utexas.edu .

Hopefully, we are one week away from a website and we will end the distribution problems.

Should Banks Be Able to Repay TARP Money When They Want?

GS, JPM and other banks have said that they want to pay back their TARP money. They **want to pay it back for several reasons**, including:

1. avoid the regulation that comes with it – particularly the compensation limits (and realize that even though banks may pay back TARP money, it doesn't mean that the government can't regulate them)
2. having TARP funds is like wearing a "scarlet letter"

Geithner has been **reluctant to permit banks to pay back** the money. Possible reasons include:

1. the market's reaction to the banks that can't pay the TARP funds back
2. fear that banks (which pay the money back) will be undercapitalized and will not have enough capital to offer the credit needed for recovery
3. the political backlash that will ensue if these banks resume paying large bonuses

Geithner has said that there are several **factors to consider** when deciding whether to allow paybacks:

1. health of individual bank
2. overall health of the financial system
3. flow of credit
4. results of stress test

My Thoughts

The idea that the banks took out a loan and should be able to repay it whenever they want is far too simplistic. There are several reasons why I believe Geithner should make the decision (and that it shouldn't be at the discretion of the banks):

1. if we have an additional shock to the system (additional unexpected defaults, act of terror, prolonged recession), we could have a huge problem if banks are undercapitalized and don't make loans
2. most of these banks have been supported indirectly by the government's support of AIG, the government's bailout of other banks and industries and the government's guarantee of bank debt, so it's disingenuous for most of them to argue that they didn't need the bailout money
3. if the strong banks pay the government back, it may be tougher for the private banks to raise private capital. That may sound like it's not a problem because the government could use the repaid funds to help the weak banks. But there is a problem with that: the government will be investing larger amounts in weaker banks and that is risky for taxpayers.

Banks Want to Renegotiate TARP Exit

The WSJ reported that the banking industry is lobbying the Treasury Department so that the banks can pay back the TARP money and the Treasury will **forgive the warrants**.

When the government gave money to the banks, the government received preferred stock and warrants (**options issued by the banks**) that were designed to give the government upside in their investment.

Banks want to pay back TARP and have the warrants expunged. The **current methodology to eliminate these warrants** is:

1. obtain valuation report from third party firm and, if government agrees with valuation, pay back that amount
2. if the government does not agree, negotiate with the government
3. if the bank and government can't agree, the government can sell the warrants to private investors

Banks have argued that forcing them to buy back the warrants is wrong for several reasons:

1. it is a prepayment penalty that makes it very difficult to eliminate the TARP debt
2. the cost may be equivalent to paying huge interest on a short-term loan
3. the payment would reduce the banks' capital and defeat the purpose of TARP
4. TARP has changed because of the addition of compensation rules

My Thoughts

The banks' position is preposterous. The preferred stock was issued with a 5% dividend because the government was also receiving these warrants. Without those warrants, the government would have (hopefully) demanded a much higher dividend rate on the preferred stock.

If you accept this argument (and I'm not quite sure why you wouldn't), the bank's desire to frame this as a prepayment penalty or usurious interest is patently absurd. The warrants were the cost of a low interest rate loan. The banks effectively issued convertible preferred stock to the government (low dividend preferred stock with options on the common equity) and are now arguing that the options shouldn't be valid. Imagine a borrower tried this argument with the bank. In mortgage terms, this would be like a homebuyer receiving a 2/28 adjustable rate mortgage (where they have a low teaser rate for two years) and then telling the bank (at the end of two years) that they should be able to pay back the original loan (and not the larger amount that is actually owed due to the negative amortization that resulted from the teaser rate). The bank would laugh at the borrower, just like we should laugh at the banks.

What Do Banks' Q1 Earnings Tell Us?

Many of the big banks reported large earnings numbers in Q1. Examples include:

1. GS: \$1.81 billion
2. JPM: \$2.1 billion
3. Citi: \$1.6 billion
4. BAC: \$4.2 billion

The question is whether this is sign that the sector is recovering. More likely, it's just a sign that, in the short term, a bank can make their earnings appear however they want (and this was made easier with the recent changes in the mark-to-market rules).

Since I spoke about GS, JPM and Citi last week, I'll use BAC's earnings this week. When BAC announced their \$4.2 billion profit, the stock slid 24%. BAC's results were largely driven by trading results (as well as interest income). But, they had significant losses in credit cards as well as home loans and insurance. Investors aren't going to get excited about trading profits (we know that they can become trading losses); rather, they are going to focus on problems with the credit quality of the bank's loans. (On the flip side, you could argue that the stock retreated b/c it already had experienced a great run.)

In addition, Bank of America's earnings had some "lowlights," including:

1. \$1.9 billion pre-tax gain from selling part of its stake in China Construction Bank
2. \$1.5 billion pre-tax gain from selling \$51 billion of mortgage-backed securities
3. a 21% tax rate
4. \$3.7 billion gain from the decrease in value of their own securities (BAC debt)

In sum, all of **the large banks' earnings were full of non-recurring events**, such as:

1. gains from sales of assets
2. gains from fair value accounting (where banks took gains because the value of the bonds that they have issued are worth less!!!)
3. lower reserves than Q4 or sometimes lower reserves than charge-offs
4. mark-to-market gains (where banks only have to write some assets down for the loss that is due to credit quality and not the loss that is due to "liquidity" issues – how you tell the difference is another story, but it makes for a pretty earnings number)

Regardless of the big earnings numbers, we all know:

1. credit card losses are going to continue to rise
2. rising unemployment will cause more pain in loan portfolios
3. the banks were anxious to show a profit to help deflect any criticism from the stress tests
4. there was a desire to have good results prior to annual meetings (particularly for BAC, where shareholders want to separate the CEO and Chairman positions)
5. a lot of strong earnings are coming from a refinancing boom and that may not be sustainable
6. some banks are currently profiting from corporate debt re-financings and the reduced competition in the market (from the demise of Bear Stearns and Lehman)

In sum, the best thing to read into the earnings' reports is that banks haven't learned anything and still feel no need to become transparent.

Bailouts for Second Lienholders?

Lets start with a simple example. An individual buys a \$300,000 house. They get a \$240,000 mortgage and a \$60,000 piggyback loan. They owe \$300K on a \$300K house. The value of the house decreased to \$200K. The homeowner now owes \$300K on a \$200K house.

The Treasury Department is reportedly considering a bailout plan for the issuers of the piggyback loan. They will be paid to either modify the terms or go away or let the house be sold for less than the value of the loan.

The Treasury's idea is that this will help to keep people in their homes. In addition to helping those particular homeowners, the entire market is helped because this house is not sold at a low (foreclosure) price.

The problem with this approach is that the second lienholder would be eliminated by the bankruptcy judge. In other words, we're paying someone who is far down on the priority ladder and this would not happen in our court system.

My Thoughts

In my example, we have a \$100,000 loss. Nothing is going to make that go away. The two questions that you have to ask are:

1. who should bear this loss
2. is there risk that this loss will increase in value

The two questions lead to different answers. With little question, the provider of the second lien should be wiped out and then the primary mortgage provider should have a smaller loss. The problem is that the house will sell in foreclosure at a reduced price and this will lead to further problems. If that's the case, what should we do?

If we could figure out how much additional loss we will incur by having a foreclosure, we should be willing to pay that amount to avoid the foreclosure. For example, lets imagine that this house will be worth \$170K in foreclosure. In that situation, the second lienholder will be wiped out and the primary lender will receive \$170K.

If we could pay the second lienholder less than \$30K to go away and then keep the homebuyer in the house, it seems like we're all better off. But there's a huge problem here – the \$30K is being paid by you and me and the benefit is being split between the two lenders and the home dweller (lets stop calling him the homeowner...).

We need to change how this will work. Here's an example of how this situation could be resolved:

1. the primary lender writes a \$5K check to the second lienholder and the second lien holder issues a release (and no longer pursues any claims)
2. the primary lender writes down the value of the loan to \$200K, the market value of the home
3. the home dweller signs two new loan agreements with the primary borrower; the first is a \$100K first mortgage and the second is a \$100K loan WITH recourse that is no dischargeable in bankruptcy

Everyone is better off:

1. the second lien holder received \$5K for a loan that was worthless
2. the primary broker now has a much more secure \$200K loan (> \$170K in foreclosure)
3. the home dweller did not have to move (and avoided the expense of moving)

The biggest issue is that we need laws that will allow (what are effectively) mortgage loans to be made with recourse and that are not dischargeable in bankruptcy. In addition, this only benefits people with enough assets to make a non-recourse loan have value.

It's a Dirty, Dirty World – The NY Pension Scandal and the Car Czar

Steven Rattner, known as Obama's "car czar", is under fire for his involvement in a New York state pension scandal. The allegations that are at the foundation of NY Attorney General Andrew Cuomo's investigation are:

1. the NY state pension fund was controlled by the NY state comptroller (Alan Hevesi served in this role until he was indicted in 2006 for other matters)
2. Hevesi determined what funds (i.e., hedge funds, private equity funds, etc.) that the state would invest in
3. In order to be selected by the NY pension fund, hedge funds and private equity funds would have to go through a "placement" firm that was politically connected to Hevesi
4. In other words, hedge funds and private equity firms have had to effectively "pay to play"

Rattner is the co-founder of Quadrangle and the allegations are that:

1. hedge funds were told by deputy Comptroller David Loglisci to use a placement firm run by Hank Morris (a Democratic strategist and an advisor to Alan Hevesi)
2. Rattner met with Loglisci's brother and, as a result of the meeting, a Quadrangle affiliated entity paid ~\$89,000 to acquire the rights to a low budget movie that the Loglisci boys were making (the film was called "Chooch")
3. several weeks later, NY invested \$100 million with Quadrangle
4. Quadrangle then paid \$1.1 million to Morris' firm

The WSJ and others have pointed out several takeaways from this story:

1. there is evidence of corruption among some public funds as politicians use this power to collect money from private firms
2. it is a myth to think that the public investors are altruistic while the private fund managers are greedy
3. these "pay to play" arrangements can often be seen through political contributions

My Thoughts

1. while hedge funds and private equity funds use marketing firms, using a placement firm for one specific relationship (such as the NY State pension) should be presumptively illegal; in other words, the presumption should be that this is "pay for play" and you can rebut this presumption with clear and convincing evidence
2. it has been reported that Rattner disclosed this investigation to the Obama administration when he was being vetted. If this is the case, it's truly an indictment of the administration's selection / vetting process. Whether Rattner is indicted or charged in any way, this behavior just reeks of corruption. Why would anyone overlook this?
3. we are at a crucial point in negotiating with the auto industry and we are spending time worrying about whether we can trust the "car czar" – and that's just not right

Ken Lewis and the Tangled Web We Weave

Earlier this year, Ken Lewis (BAC's CEO / Chairman) testified in NY Attorney General Andrew Cuomo's investigation of Merrill Lynch's December bonus bonanza. During the testimony, there was discussion concerning BAC's failure to disclose ML's problems to BAC's shareholders prior to the merger going through. This week, Cuomo released some documents describing Ken Lewis' testimony.

Lewis' testified that:

1. Fed Chairman Bernanke and former Treasury chief Henry Paulson pressured Lewis to not discuss ML's problems
2. Bernanke and Paulson told him that if the deal died, it would create risk for the entire financial system
3. Paulson and Bernanke said that Lewis and his Board would lose their positions if the ML deal failed

Key Thoughts

1. Paulson and Bernanke sound as if they were willing to push Lewis to violate his obligations in order to protect the financial system; it's scary when people think that the end justifies the means
2. BAC's shareholders incurred losses for the rest of us (i.e., the cost of saving the system was placed on private investors)
3. The government bailed out BAC as a result of BAC's willingness to do the ML deal and now we have no idea whether the government will treat BAC differently as a result of this sordid relationship
4. Regulators may have encouraged Lewis to disobey the law
5. Companies are required to disclose material information to shareholders. In this case, if the information had been disclosed, BAC's shareholders could have voted against the merger. In that situation, ML probably would have collapsed.
6. What will the SEC do in their investigation? This is a dirty situation involving some of their fellow regulators.
7. Lewis tried to get Bernanke to put it in writing that the government would support BAC. Bank of America received \$118 billion in loan guarantees to absorb potential losses from the Merrill acquisitions.

Lewis' spokesman is now taking the position that they had no legal duty to disclose negotiations with the government. When asked whether Paulson and Bernanke were effectively asking BAC's shareholders to take the hit, Lewis said, "Over the short term, yes." You see dumb reader, you need to understand that this may hurt "over the short term," but in the long term, grossly overpaying is how BAC creates value for you.

There are so many questions to ask Ken Lewis. What is his position: that the government made me do this acquisition or that this is a great deal? I wish we could just have him commit to one answer. I also want to know whether he consulted with an attorney or did he just rely on what he was told?

Don't lose sight of the fact that Bernanke and Paulson did not force Lewis to enter into this deal. After that, don't forget that Lewis had a duty to protect his shareholders. He should have sought legal counsel and fought this alleged pressure. **IF EVER THERE WAS EVIDENCE THAT SOMEONE IS NOT QUALIFIED TO HOLD THE JOINT POSITION OF CHAIRMAN / CEO, THIS IS IT.**

Update on the Real Estate Market

There is still **weakness and uncertainty** in the housing market. Existing home sales data was released this week and revealed:

1. sales of existing homes dropped 3% to an annual rate of 4.57 million homes
2. while sales dropped, they were still higher than the recent January low of 4.49 million homes (on an annual basis)
3. the median home price dropped 12% (YOY) from \$200,100 to \$175,200
4. distressed properties accounted for ~50% of all sales
5. the number of homes on the market dropped 1.6% to 3.74 million homes – 9.8 months inventory

Data on new home sales was also released:

1. sales of new homes dropped .6% to an annual rate of 356,000
2. new home sales peaked in July 2005 with an annualized rate of 1.389 million homes
3. the median home price decreased to \$201,400, the lowest since December 2003
4. inventories dropped 5.2% (faster than sales) – inventories are at 10.7 months

In the past few months, we have seen the following mortgage trends:

1. mortgage rates have dropped YOY from 6% to 4.73% for a 30 yr fixed rate mortgage
2. people are refinancing to lower their fixed rate or change an adjustable rate to a fixed rate (which is particularly important if you believe that we will have inflation in coming years)
3. some people can't refinance because their home has dropped in value and they have no equity
4. currently, the vast majority of mortgage applications (~80%) are for refinancing

Thoughts on the Housing Market

The housing market is particularly difficult to follow or understand. While we look at price **indexes**, they are **misleading** for a variety of reasons, including:

1. homes are unique and it's impossible to capture these differences (or improvements vs deterioration in homes)
2. indexes are being impacted by distressed sales and that doesn't mean that an average home would be sold for that price (unless it was also a distressed sale)
3. one widely followed index (the Federal Housing Finance Agency index) only captures homes financed with loans owned or guaranteed by Fannie or Freddie and the result is that it excludes most homes purchased with subprime loans; that index was only down 6.5% YOY (and up .7% last month)

We have great uncertainty in predicting future home prices for several reasons, including:

1. the importance of unemployment rates and mortgage rates
2. the significant drop in number of people who are moving (only 11.9% of people moved last year – the lowest percentage since 1948, when the Census Bureau started collecting this data)
3. the number of months inventory data is also misleading; while I have spoken for months about the fact that people are not listing their homes (lowering the numerator), the denominator could also spike up (the annualized sales) and suddenly the index would be in more normal ranges
4. sales are being driven by the federal tax credit for first-time buyers as well as a California tax credit

Clamping Down on the Credit Card Issuers

In December, the Fed imposed new rules (which will take effect in July 2010) on credit card issuers, including prohibitions against:

1. unfair time constraints on payments (should have 21 days to pay)
2. unfairly computing balances using double-cycle billing (explained below)
3. adding security deposits and fees
4. applying payments (above the minimum payment) to lower interest rate balances rather than higher interest rate balances

Quick Explanation on Double-Cycle Billing

When you calculate interest, you multiply the average daily balance x the APR/365 x number of days in the period. In a typical 30 day period, you would think that the average daily balance is simply the average outstanding balance over those 30 days. But, with double-cycle billing, the average daily balance is the average amount outstanding (on a daily basis) over the last two periods. If you have the same amount outstanding in each period, you won't be affected. If your amount outstanding grows each period, you are actually helped by this. As your balance comes down, you are hurt by this. You are particularly hurt by this if you occasionally have a balance outstanding, but normally pay it off. Even in the month after you pay it down, you are still being charged interest on the amount from the prior month.

This past week, the House Financial Services Committee approved legislation that:

1. incorporated the Fed's regulations into law (making things a little more serious for credit card issuers)
2. requires advance notice of increases in interest rates
3. bans retroactive interest rate increases on existing balances unless the cardholder is more than 30 days late on a payment
4. prohibits marketing to people under 18

The bill passed 48 – 19 with eight Republicans siding with the Democrats. A somewhat stronger bill (that would prohibit increasing interest rates for cardholders who are in good standing) has been proposed in the Senate (by Senator Dodd). In addition, Senators Dodd and Schumer have written the Fed to ask for emergency action to immediately implement the regulations and to halt interest rate increases on existing balances.

Finally, President Obama met with the credit card executives. He voiced his desire to see four things done:

1. an end to “anytime any-reason rate boosts and late-fee traps”
2. plain language statements without fine print and “no more confusing terms and conditions”
3. the availability of comparison shopping for credit cards (easy to compare terms)
4. more effective oversight of issuers

Some Thoughts

Credit card issuers have themselves to blame for these problems. In good times, they failed to do necessary credit analysis to determine who should receive credit. (The issuers often relied on home equity to justify credit.) Now, in bad times, they are slashing credit lines, raising rates, closing accounts and even imposing these changes on people who are not behind on their payments. It makes sense to take some of these actions, but no one trusts them as a result of “double cycle billing” and other practices. Many of these issuers also have TARP funding, so the gov't is all over them.

The issuers will tell us that these changes will result in many people not getting credit and the rest of us paying higher rates. (Of course, some of us paying higher rates does not scare the Administration – that's their tax policy.) They will also argue that they have to pay higher funding costs and surging delinquencies. But, at the end of the day, the general public is not going to sympathize with companies that extend credit to people who can't handle it and then lobby for changes in the bankruptcy law.

Finally, a few random stories, many of which should irritate you...

1. The WSJ argued that the government misled us when they said that lending declined 2.2% among the 21 largest banks that have received bailout money. The WSJ said that the 2.2% is the median (half the banks saw loans decrease more than 2.2% and half the banks saw loans decrease less than 2.2%). The WSJ argues that the number should be the average. I agree with the WSJ – if we care about the amount of lending that is going on, we care about the average. Imagine 10 banks cut lending by 2.1%, one bank cut lending by 2.2% and ten banks cut lending by 60%. In that case, the median is a drop of 2.2%. While I'm irritated at the government's use of median, I'm even more irritated by the WSJ, as they left out Wells Fargo (which accounts for 24% of the new loan market!!!) and increased the amount that they loaned. The WSJ said that they couldn't break out WFC's numbers because of the Wachovia acquisition.
2. There is a program called Trade Adjustment Assistance that gives added benefits to workers who are displaced because of imports or production shifts out of the country. I'm pissed that this ever existed, but I'm particularly irritated that we have enhanced the benefits and we are going to start offering them to service workers (such as call service reps). Among other benefits, these people will get 2.5 years of cash benefits plus schooling. There are two huge problems with this: (1) there's no way to distinguish who is being hurt by shifts outside of the country – we could argue that for every industry; and (2) there's no reason that this person is deserving of more benefits than someone who has lost his job due to American competition, a slowing economy, a dishonest employer, etc. It makes no sense to me. Apparently, the program costs \$1 billion. If we didn't piss that money away, we could have subsidized bigger bonuses at Merrill Lynch.
3. Pepsi made an offer to buy its two largest bottlers. Just ten years ago, they wanted to focus on soft drinks, so they spun off the bottlers. It's got to be great to be a banker – sell an idea and then put it on your calendar to unwind the idea in the future. Nice work if you can get it.
4. Pepsi is being advised by Bank of America and ML. So here's my question...BAC drove themselves into the ground by overpaying for Countrywide and ML. Who thinks, "wow, I need to get BAC to advise me on a deal?"
5. The government is raising the possibility of converting more of their preferred stock investments into equity (of the troubled banks). Supposedly, this will be done to protect our investment. Here's my question...you are giving capital to a failing business...would you rather receive fixed preferred stock dividends or speculate on their survival and not receive dividends? This is just part of the "bailout two step" where we make an investment and then give up our right to earn money on our capital.
6. AIG is considering expanding their Board. Currently, they have 11 directors. Here are the problems with this: (1) 80% of the company is owned by one shareholder – the US; and (2) there's plenty of academic research showing

- that larger boards are ineffective. Common sense tells us that we can't have 20 people overseeing something.
7. Neil Barofsky, the inspector general in charge of overseeing the bailout plan, issued a report to Congress blaming the Treasury dep't for not making banks disclose how they will use bailout funds. While this makes sense in theory, it's moronic in practice. Imagine I'm giving money to my child in college and I tell him to use the money for books, not beer. He puts the money into an account, buys books and sends me the receipts. The bottom line is that he now has extra money to buy beer. It's no different with the banks. They use money to make loans or replenish capital...they are now more able to pay bonuses or provide perks. You can't win this game. You can, however, put restraints on a bank before you provide funds – e.g., “no beer.” If you don't have those restraints, you have problems.
 8. In his report, Barofsky made two points that I completely agree with. He complained that the non-recourse loans create the possibility that the private investors (in the public private partnership) may just walk away and stick the government with more losses (see my earlier discussion of Geithner's plan for the same argument). He also complained that the Fed will not be examining these legacy assets – they will be relying on credit ratings agencies. That's awesome – we're going to rely on the same people who originally rated these securities AAA. This is like hiring Bernie Madoff to handle the investments of the people who he defrauded – to help them recover. If we were any dumber, we'd reward ratings agencies with higher compensation for higher ratings.
 9. Chinese Premier Wen Jiabao called for more surveillance of countries that issue major reserve currencies. He was indirectly criticizing the United States. Here's a news flash China: our currency would be a lot stronger if the Chinese actually paid for all of the intellectual property that they steal and use.
 10. GM is apparently willing to sell their Opel brand and their Saab brands (separately) in transactions in which GM will receive zero. I'm relieved to see that we've finally accurately valued these brands...they're worth zero. In reality, GM should have to pay others to get some of their brands taken off their hands.