

Minyanville's Rob Roy: Default Swaps Intensify Credit Crunch

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By Rob Roy

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Editor's Note: This article is a collaboration between Bennet Sedacca and our newest professor Rob Roy. Rob is the co-Chief Investment Officer at Atlantic Advisors. Please join us in welcoming Prof. Roy to the 'Ville!

Over the past several years my firm has highlighted the risks in the sub-prime sector, the lax lending standards, and the housing bubble that peaked in 2005. The residual effects of these have been vast and continue to support our view that the unraveling of the debt issue is not contained.

Housing is clearly in a near-death spiral with inventories rising on months of available supply basis, despite many homeowners de-listing their homes and waiting for a turnaround. Here in Orlando there is 5 years worth of available home lot inventory waiting for developers to fill in the new suburban subdivisions that were developed. According to my firm's industry sources, a real turnaround in housing on a macro level will not likely begin until 2009-2010. This is sobering stuff to be sure, but the truth usually is in the markets.

Abnormal events are magnified with financial leverage, and even normal events can become catastrophic with large amounts of leverage. This is clearly seen with the sub-prime and other low quality loans that were packaged into Collateralized Debt Obligations (CDOs) and then sold off to institutional investors thirsty for higher returns. Other financial "alchemy", courtesy of Wall Street's greatest quantitative minds included upwards of \$300 billion of Structured Investment Vehicles (SIVs). The SIVs took in a lot of mortgage paper (both commercial and residential), added some leverage to the recipe, and then issued a package of commercial paper/equity/junior notes/senior medium term notes (MTNs). These investments (We use this word loosely and prefer 'derivatives') were 'stress tested' for normal delinquency rates. Of course now they realize that these are not normal times.

My firm believes it is dangerous to use history as a guide in today's complicated environment. Instead, we believe that we are now making financial history and when we look back twenty years from now, we will see today as the unwinding of the 'Great Debt Experiment'. Which leads me to what we believe what is the greatest risk of all: Counterparty Risk. Counterparty risk, simply defined, is the risk that the other party in an agreement will default.

The Great Debt Experiment

Ever since 1999 we have been concerned with the amount of debt at every level across the globe. In an 'asset based economy' (or as I like to say, a 'debt induced economy'), both sides of the balance sheet tend to expand at the same time. I recall reading in the press at the peak of the housing bubble in 2005 that 'household net

worth has reached a record high'. This occurred while stock prices remained far below their 2000 peaks and was almost completely attributable to the parabolic rise in home prices across the U.S. Note that this was not a situation contained to just the U.S. but was also occurring in Europe and the South Pacific, notably Spain and Australia.

At a panel in New York at 2006's Minyans in Manhattan, Prof. Sedacca was asked the following question by his friend Michael Santoli, Chief Editor of Barron's:

'Bennet, you seem very negative on the debt markets and are very cautious about credit, but, do you think it is possible that the United States is the best house in a bad neighborhood?'

This was a great question and one that is being answered today in real-time. Despite weakness in our economy and in our equity and credit markets, the US equity market measured by the Dow Jones Industrial Average and S&P 500 are among the best performing around the globe with losses 8 to 10 percent year-to-date. Other developed markets in the world are suffering losses closer to 20% year-to-date and it is only February 7th! The dollar has been rallying lately, which is contrary to what you might think, but what if the US actually is the best house in a bad neighborhood? Could the dollar rally against the Euro as the problems at European banks like Union Bank of Switzerland, Societe Generale, Deutsche Bank (DB), Barclay's (BCS) and Credit Suisse (CS) surface day after day? Every day it seems, a new financing is announced by a major bank (lately by the likes of Citi (C), PNC, and Wachovia (WB) just to name a few) in order to 'shore up capital'.

Why are they shoring up capital? Because they have a problem, a really big problem. The economy has slowed into a recession to be sure, the depths of which will not be known until long into the future. They have balance sheet exposure to other banks and to the 'monolines', like Ambac (ABK), MBIA (MBI) and FGIC. Just last night, MBIA placed \$1 billion equity financing in order to keep its AAA rating. This comes after a \$1 billion subordinated debt issue meant to accomplish the same thing. What comes after you issue debt, and then have to issue equity? Regardless, the bonds trade at CCC levels, so the market, including my firm, isn't buying it. If you were a bond issuer needing insurance, would you call Warren Buffett's brand new municipal bond insurance business or would you call FGIC, who has already been downgraded to Aa2/A and on negative credit watch by Moody's? Would you call Warren or MBIA or Ambac?

The bond insurers used to have sound business models that simply charged a fixed fee to municipal issuers that have very low historical default rates, particularly when compared to their corporate bond counterparts. But then like everyone who reaches for just a little bit extra, they wandered off the reservation and into the world of structured finance (a.k.a. leveraged finance). Soon they were insuring tranches of CDOs, CDO Squares (leverage on leverage on leverage), and other structured finance deals for higher fee

levels. These new types of insurance brought in higher revenues and magically their earnings jumped which caused their stock prices to soar. One hundred dollars invested in MBIA stock at the end of 1999 would have been worth just more than \$200 by the end of 2006, while the same amount invested in the S&P 500 would have only been worth just less than \$100 (not accounting for dividends)!

So great earnings were created by adding leverage on top of leverage on top of leverage. And they were already insuring hundreds of multiples of their capital base in the municipal bond market. Well, unfortunately we entered a period where things were not quite as normal as the stress-tests implied, and now we have insurance companies that are teetering on the brink of insolvency. Your original \$100 dollars in MBIA stock would have reached its peak at about \$208 in late 2006, and would now be worth about \$40. Nice ride while it lasted.

Now enter the regulators, like the Insurance Commissioner of New York, Mr. Danalli. To solve this situation, the regulators are asking banks like Citi and a bunch of European banks (which already have their own funding problems) to 'bail out the municipal insurers'. Supposedly we can't let them fail because the result would be too large and would finally hit the individual municipal bond investor right between the eyes. According to research from Citi, of the \$2.5 trillion of municipal bonds outstanding, \$911 billion are owned directly by individuals and approximately \$500 billions more are in closed end and open end municipal bond funds.

The problem with this potential solution is that the bailors (banks) have the same balance sheet problems as the bailees (insurance companies). The banks have hundreds of billions of dollars of exotic paper that they really don't know how to price, yet if they let the insurers fail, they will be forced to write down their own positions simultaneously. This becomes one vicious cycle of capital raising in the banking and brokerage industry...

...Oh yes, the brokerage industry. If you think the banks are a mess, try taking a quick look at the balance sheets of companies like Lehman (LEH) and Bear Stearns (BSC). These companies have balance sheets that are literally 40 times their shareholder equity. They also own 3 times their equity in what is known as 'Level 3 assets'—those that can't be accurately priced, and can't even be estimated based on a model. Level 3 is 'mark to management's best guess'. Best guess is better than what Citi's CFO said when asked about its \$60 billion of CDOs. On the investor conference call he stated that their positions were 'marked to a reasonable stab'. I know this may sound as if I am making this up, but sadly, I am not. In Citi's case, this was before they brought approximately \$45 billion of SIVs back onto their balance sheet in late 2007. This explains why the banks, brokers, and insurance companies are constantly coming to market to raise fresh capital.

This cross-dependency on other institutions is why counter-party risk may be the next problem child to raise its ugly head and may be the greatest risk of them

all. We have been hearing the murmurs of counter-party risk for the last several years. The last measure of the credit derivatives market is \$45 trillion (yes with a T) which didn't happen overnight. Like any big disaster, it didn't reach its tipping point in an instant but rather built up over a substantial time period where warnings were not heeded.

The risk isn't just that the other party to your derivative trade suffers a financial meltdown and can't pay. Counter-party risk really seems to take on three types of events. In the most widely understood event, a trade in which you are winning and are owed money by the counter-party isn't paid to you because of their inability. This first risk is pretty simple, but even so these kinds of failures may cause you enough pain to pass the problem down the line by creating an inability on your part to pay your obligations. This is a daisy chain effect.

The second kind of counter-party risk is that these private transactions which are agreed to in complicated legal documents have not been properly documented. Many credit derivative transactions don't simply involve two parties but are often times the risk is passed from one party to the next several times. When an event occurs it causes a careful examination of the complicated legal documents which spell out the specifics of solving a default event.

In a legal case from last year, Bear Stearns loaned \$10 million to a development in the Philippines which was backed by a Philippines government agency. In order to protect itself from default, Bear Stearns purchased protection from AON for about \$425,000. AON was then short exposure to the Philippines government agency, and so then purchased protection from Societe Generale for \$328,000. Offsetting the risk gave AON an easy \$97,000, right? Well the project went bust, the developer did not pay and neither did the Philippines government agency. Bear sued AON for \$10 million to reclaim their loss under the Credit Default Swap it had purchased from them and AON paid. AON then went and sued SocGen for \$10 million asking for a summary judgment claiming that since the one CDS had been resolved it should automatically create a resolution for the second CDS. After several courts opined on the case, AON lost their case, and lost \$10 million. The final court ruling was that the language in CDS1 and CDS2 were not identical and that the risk was not purely offset. So instead of making \$97,000 they lost \$10,000,000. Seems like documentation is a real counter-party risk.

The third kind of counter-party risk is one of hesitation. When you are in the finance business you require funding and counter-parties in order to produce your products and to keep a massively leveraged balance sheet in place. Even if your funding and transaction sources simply hesitate to do business with you for fear of creating additional risk for themselves, you can suffer nearly instant insolvency. We saw this with Drexel Lambert, Long Term Capital Management, and a host of others over the years. Currently we are seeing this with the SIVs and the CDOs that require continuous short term funding in order to keep the balance sheets alive. We nearly saw it with Countrywide late in 2007, and I fear that we are going to see it again during this credit unwinding. But with the leverage in place today, these possible events will likely be much larger.

This issue has reached a critical state which is term reserved for events that

have built up enormous pressure and cannot be relieved gently. Only three things can happen to debt. It can be paid off; serviced (pay the monthly interest) or it can be defaulted. We have long since passed the point where there are enough financial resources to pay off the debt, and we are probably nosing past the point where the monthly minimum can be covered. This only leaves us with one more possible event and that is default. The intricate web of risks that criss-cross the financial world and have been cleverly distributed among the players will be difficult to resolve.

Because of this possibility we at Atlantic Advisors continue to avoid credit risk for our clients. In fact, we are short credit risk in our Harbor Pilot Fund via preferred issues of financial companies, which are hedged against long positions in Government Sponsored Entities such as GNMA (Ginnie Mae), FNMA (Fannie Mae) and FHLMC (Freddie Mac).

The big question now is, if you have a derivatives contract, CDS, or CDO with another institution, you may start to wonder if your counter-party is sound, and if it is properly documented. I have a sinking feeling that this may be the next, and biggest shoe to drop, and the shoe that will potentially wreak havoc on credit markets and even the global equity markets. Your derivative trade may have turned out to be a great idea and conceptually there is a positive payoff due to you. But what if your counterparty is embroiled in some other mess with AMBAC, MBIA or some exotic basket of CDO's and they cannot make good on your trade? Do you have recourse? Even for a simple trade, with no leverage, based on liquid markets like S&P 500, these are private deals between two parties, and the trade was an obligation of your counterparty.

This is the largest risk we see going forward for the financial markets, when investors do not trust their counterparties, when counterparties suddenly decide to pull your financing due to 'balance sheet constraints' (this has actually happened to many funds, corporations and municipalities of late), and when financial institutions do not trust each other that 'the other side of the trade will settle'. This helps explain the large spike in LIBOR versus the effective Fed Funds rate last summer, a situation that was eventually corrected by the ECB injecting \$500 billion into the money markets to bring LIBOR rates down in line with the Funds rate. LIBOR spiking versus the Fed Funds rate is likely the most reliable sign that financial institutions fear counterparty risk. Unfortunately, we think that was Act I in a larger story that will unfold in the future and we will be closely monitoring LIBOR rates in relation to the Funds rate. While the \$500 billion injection by the ECB and the emergency measures taken by our Fed (such as emergency discount windows, surprise rate cuts, unlimited cash and other rhetoric) worked for a short time, Act II will likely be much more hostile and catch many unseasoned, poorly positioned investors by surprise.

If and when counterparty risk rears its ugly head, the curtain on this play may fall, and fall hard. It is at that point that we will look to take more risk for ourselves and for our clients and partners. After all, fear breeds opportunity. Just ask Warren Buffett or the board of MBIA (who had to sell \$1 billion of Surplus Notes last month at 14% to stave off a downgrade from its coveted AAA rating and just last evening had to sell 82.3 million shares at \$12.15 per share last night, a 14% discount to its closing price and a whopping 80% below its price of just one year ago). I most certainly would not

want any counterparty risk with an institution that is that leveraged and desperate and likely to fail.

While much of this piece focuses on problems we see in the markets, we feel that the current environment and the environment we envision in the not too distant future will usher in opportunity for those of us that have been prudent in managing the capital that is entrusted to us. We are proud to have gone against the crowd when it was most difficult in times of greed, but we intend to closely monitor the mood of the market as greed makes its eventual move to fear, at which point we intend to pounce. The times in front of us may be volatile and perhaps tumultuous, and that will be the time of great opportunity.

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