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INVESTMENT BANKERS

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Instability on Wall Street Affects Main Street

As major financial institutions are caught in a vicious cycle of deleveraging, credit is contracting.

by Michael T. Newsome

Turmoil in the credit markets accelerates as investor confidence is shattered and we watch erstwhile Wall Street titans fall. As we submitted last spring in *Insight*, major financial institutions are caught in the thrall of a vicious cycle of forced deleveraging of their balance sheets. It is a relentless downward spiral of asset values that erodes capital and drives away lenders. Imprudent application of leverage is at the root of the crisis, but it has been the loss of liquidity (timely access to cash) that laid low Bear Stearns, IndyMac, Freddie, Fannie, Lehman, and AIG. To borrow a line from the Wall Street Journal, "in the Fed's and Treasury's game of whack a mole, the moles are winning." The pace of events has picked up. Credit is contracting with the impact landing squarely on the largest and most sophisticated players in finance, with no clear end in sight. Why?

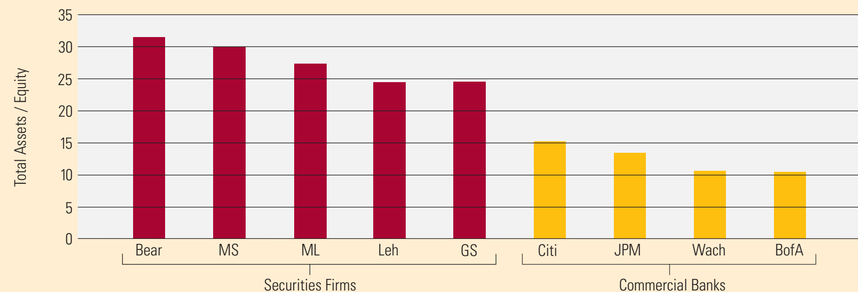
Though there has been much chatter fixing blame on insidious short sellers and speculators, it is not widely understood why the major securities firms (Bear Stearns, Morgan Stanley, Merrill Lynch, Lehman Bros and Goldman Sachs) proved so vulnerable to panic. The answer is found in the intricate and opaque funding strategies employed in the financial markets.

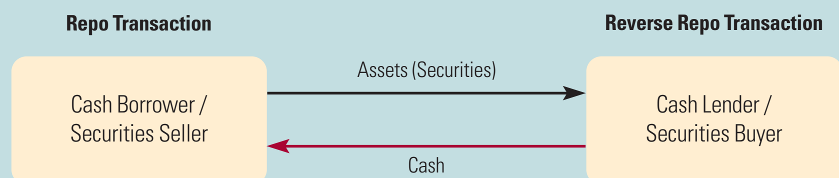
These non-depository firms and many other financial institutions fund their asset bases with a mixture of short- and long-term debt, coupled with a sliver of equity, in many cases, a wafer-thin sliver on the order of $1 for every $25 to $30 of assets. For these firms, the key sources of short-term "hot money" funding have been commercial paper and repurchase agreements ("repos")[1], where a securities firm or bank agrees to sell owned and/or borrowed securities (treasuries, asset-backed paper, and other financial instruments) to counterparties in exchange for cash. The sale is conditioned on the mandatory repurchase of the securities on a date certain for the original price plus a spread. In effect, repos are secured lending transactions, where borrowings are subject to advance rates and margin requirements on pledged (sold) securities in order to address swings in collateral value. Among the major, previously freestanding securities firms, repos provided between 30% and 45% of all debt capital. In less volatile times, repo markets have been large and liquid, with well-established processes. As such, they served as a cost-effective source of funds, never presenting the challenges cropping up now.

Traditionally, securities firms supplemented repo funding with the issuance of unsecured commercial paper, which is available only to the most credit worthy. A faint whiff of lost confidence sends buyers hustling to the door, a classic example of "hot money."

In the repo market, the concern that has emerged is not default risk—the possibility of coincident failure of both borrower and underlying collateral is remote. The real vulnerability is liquidity risk to the party holding the securities as collateral. In today's extraordinarily volatile financial markets, lenders to securities firms, for fear of losses, cannot bear the prospect of taking possession of and liquidating their security. As securities firm borrowers, such as Bear Stearns, Lehman and Morgan Stanley, began to look shaky, the securities lenders pulled back by decreasing advance rates, shunning illiquid collateral, shortening maturities, or worst case, suspending lending altogether. Measures taken to invoke greater conservativism, unfortunately, stoked borrower instability.

Of course, one might wonder what the issue is. If funding evaporates, simply sell the collateral assets on the open market and carry on. The flaw in this logic is that the use of the repo market has expanded far beyond highly liquid securities (e.g. Treasuries, or blue-chip bonds), which have deep and active markets. The repo addiction is so pervasive that repo-market lenders are over exposed to illiquid collateral that cannot be quickly converted to cash without suffering severe devaluation. At the heart of the problem is a classic asset—





[1] *These transactions are referred to as repos from the borrower/securities seller perspective and "reverse repos" from the lender/securities buyer viewpoint. The names simply refer to the perspective of buyer or seller in the transaction.*

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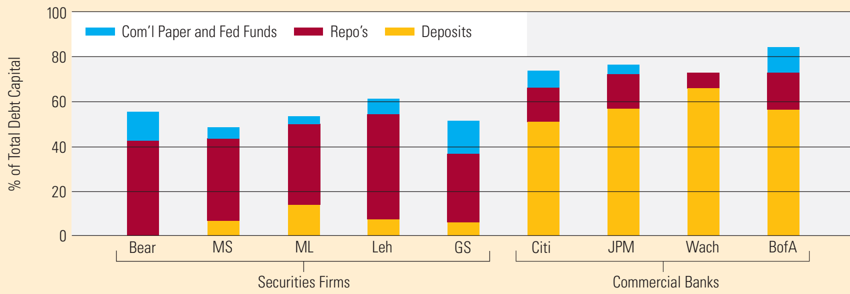

liability mismatch, where the average duration (maturity) of the repo liabilities is much shorter than the duration of the assets financed. This mismatch means that borrowers' funding must be frequently rolled over within a much shorter timeframe than the corresponding assets can be liquidated. In other words, securities firms and their lenders have engaged in transactions having tremendous refinancing risk in a jittery market.

BIGGER THAN IT APPEARS

It turns out that the use of repos to fund the balance sheets of securities firms is but the tip of the iceberg. Beyond funding to support owned assets, there is an enormous volume of highly complex, collateralized securities lending (repo and reverse repo) by the major securities firms, primarily to provide capital to hedge funds. Most of the activity is off-balance sheet and only reflected in the footnotes of SEC filings, the latest of which (2Q-08) amounts in aggregate to nearly $3.5 trillion. Only a few months ago, prior to the forced sale of Bear Stearns and the rapid collapse of Lehman Brothers and AIG, this activity was unremarkable. As information becomes disclosed, it is apparent that the sheer size of repo financing activities has had implications to the interconnected market of lending in the financial system and brought into question securities industry solvency and the continuing ability of the financial markets to function.

COMMERCIAL BANK VULNERABILITY

In contrast to the repo funding on which securities firms depend, commercial banks rely on deposits as the dominant funding source, as reflected in the above chart. Like repos, deposits can be "hot money" vulnerable to customers' fears. Witness the overnight collapse of IndyMac Bank, triggered by comments carelessly uttered by a U.S. Senator, and now, the forced sale of Washington Mutual, where nearly $17 billion of deposits bled off over 10 days as the bank sought a buyer. Nevertheless, with the comfort of FDIC insurance, bank deposits have proven to be surprisingly resilient amidst the turmoil.

As all are now aware, an unprecedented liquidity crisis pushed financial markets to the brink of disaster in mid-September, triggering the Lehman Brothers bankruptcy, the federal takeover of giant insurer AIG, the shotgun embrace of Merrill Lynch by Bank of America, Washington Mutual by JP Morgan and Wachovia by Wells Fargo, and an overnight conversion of both Morgan Stanley and Goldman Sachs to bank holding companies. As this is being written, the Federal Reserve and the U.S. Treasury pushed through emergency congressional action targeted toward soothing investor fears by moving impaired securities and loans from bank balance sheets to a newly formed federal agency to serve as buyer of last resort and liquidator. Even with the passage of a "bailout" plan, there is no assurance that the credit crunch will be quickly arrested. The market is almost certainly in an unstoppable process of wringing excess leverage out of the economy.

For businesses and industries that are dependent on external credit, even if they are far afield of housing and finance, some tough sledding is in store. As the major securities firms have found in spades, there is one thing that every company must have to survive – uninterrupted access to CASH. This is a time when the management and owners of businesses would be well served to carefully tend their credit relationships and conserve liquidity. ❖

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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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