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Interview of Eisenbeis and Kotok by Chris Whalen of Institutional Risk Analytics

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Liquidity vs. Solvency: Interview with Bob Eisenbeis and David Kotok
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"Mr. Chairman, we have in this Country one of the most corrupt institutions the world has ever known. I refer to the Federal Reserve Board and the Federal Reserve Banks, hereinafter called the Fed. The Fed has cheated the Government of these United States and the people of the United States out of enough money to pay the Nation's debt. The depredations and iniquities of the Fed has cost enough money to pay the National debt several times over... This evil institution has impoverished and ruined the people of these United States, has bankrupted itself, and has practically bankrupted our Government. It has done this through the defects of the law under which it operates, through the maladministration of that law by the Fed and through the corrupt practices of the moneyed vultures who control it."

Rep. Louis T. McFadden (D-PA)
Chairman
Committee on Banking & Currency
US House of Representatives
Congressional Record/Page 12595
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First we must pause to note the passing of our friend Mark Pittman of Bloomberg News. He died last week of a heart attack. Mark was one of the great men of financial journalism. He led the fight to force the Fed to release details of its corrupt bailouts for AIG and other insolvent financial institutions. We shall carry on that fight in Mark's memory.

We publish this issue of The IRA as the global financial markets seem to be teetering on the brink of a new period of instability. The final Q3 2009 data from the FDIC is loaded into The IRA Bank Monitor and, as we reported several weeks ago with our preliminary results, stress in the banking industry is up from Q2 2009 and by a significant margin.

The number of FDIC-insured bank units rated "F" rose from 2,256 at the end of June to 2,337 as of Q3 2009. Even with the heavily subsidized money center banks added back into the equation, the Stress Index results suggest that the US financial services sector is still sinking bow down under the weight of the highest loss rate experience in the post-WW II period. Whereas 2008 was about fear, 2009 has been about buying time. But now dwindling cash positions inside some of the largest financial institutions and investors seem to suggest that 2010 will be about resolution, whether we like it or not. This suggests that the economy will muddle along through next year and that the 2010 US mid-term elections could be problematic for all incumbents.

With the apparent default by the leading government-owned holding company in Dubai, investors have been reminded that solvency remains a core problem in the global economy despite ample official liquidity. While the Fed and other central banks have thrown a great deal of fiat paper money at the solvency problem, many obligors still have piles of liabilities that were predicated on price levels and volumes in many markets that no longer pertain. Ponder why the government of China might publicly state that its banks need more capital and the next leg of the proverbial systemic risk stool may come into sharper focus.

One of the initial solutions offered to deal with the problem of insolvency in financial institutions is mandatory convertible debt or "CoCo" bonds. This is a capital finance mechanism we have long advocated because it provides additional funding for large banks to absorb losses without liquidating the entire enterprise. The advocates of "Too Big To Fail" or TBTF are right to say that sudden liquidation of a global bank is unreasonable. CoCo bonds solve this issue by allowing a partial liquidation of a bank's portfolio without a legal liquidation of the company.

To that precise point, Robert Eisenbeis of Cumberland Advisors of Vineland, NJ, wrote in a recent commentary:

"Lloyds Bank has announced its intention to exchange outstanding subordinated debt for a new debt instrument that would be converted to common equity if its capital ratio declined below a critical value. Specifically, in the Lloyds proposal, the security would convert when its Tier 1 capital ratio fell below 5%. The instrument is called contingent capital and has recently become the latest fad among regulators both in the US and abroad. It has even been incorporated into Senator Dodd's recently introduced financial regulatory reform bill as a means to bolster bank capital positions. Sounds like a good idea, right? Especially if an institution can be recapitalized at no cost to the taxpayer. The instrument is billed as providing an additional buffer should an institution fall on hard times. But does it really and is it the panacea that regulators see?"

The IRA spoke to Bob and David Kotok of Cumberland last week.

The IRA: So Bob, David, congratulations on announcing your new office in FL. We were on the radio last week with Dr. Karl Case, founder of the Case-Shiller Home Price Indices. He is not convinced that real estate in FL has bottomed yet. Indeed, between his comments and the Q3 2009 data from the FDIC, we are heading into year-end expecting a rough ride in 2010.

Kotok: Thank you. We are expanding with a new office in Sarasota. For us, it has been two great growth years and the firm is larger in assets, head count than ever before. Many of the new clients are in Florida. Our people are finding property at 40% and 50% of recent valuations and that makes it easy for us to move staff. Climate and friendly tax structure certainly help. We think the Florida property problem is old news; everyone will tell you about it. That seems like a sign of a bottoming process to me.

The IRA: Ah, take note that Kotok is optimistic about FL real estate. Bob, you wrote an interesting comment about contingent capital for banks this past week. You are pointing out some very obvious issues, chief among them is that given the way in which the G-20 nations have been subsidizing the bond holders of the largest banks, what is the point? Do you believe that we can restore market discipline to our financial community after such a reckless expansion of TBTF and the benevolent corporate state? It's like having no-fault insurance for auto accidents for decades, but then returning to strict liability. Are these convertible CoCo bonds really workable? This represents a pretty big change from the current socialist policy.

Eisenbeis: I presume you are asking whether firms will actually find it attractive to issue CoCo bonds, but more importantly, will they work as a means to address the too-big-to-fail problem and will the regulators have the will to force conversion?

The IRA: Yes and to actually force conversion. We've been arguing for debt to equity conversion to fix the money centers for over a year. But debt conversion is a pretty big departure from the free ride that Tim Geithner and his colleagues at the Fed have given global bond holders under TBTF. The officials of the Fed wrote the bond holders of Bear Stearns, AIG, Wachovia and Merrill Lynch a check c/o the US taxpayer. Eventually the Fed will be calling for tax increases to pay for this generosity. Our mutual friend and fishing companion Josh Rosner, as well as other colleagues in Washington, fully expect a VAT to be proposed by President Obama to pay for the global financial fiasco.

Eisenbeis: The one thing that is now evident is that a lot of the regulators are at least talking about CoCos. Lloyds Bank has actually issued CoCos, but their case is a little different because investors have been given the option to exchange a piece of paper that is not worth anything, that is not paying dividends at this point, for another piece of paper. It is not likely that the UK government will let that institution go under, so sub-debt holders might as well convert. But I don't think that the Lloyds example is a good parallel for what might happen more generally should regulators adopt the CoCo model. Everybody is looking for a way out of TBTF. Some are perceiving CoCos as a way to get some market discipline back into the process. Whether it will be credible or workable depends critically upon the trigger mechanism. If the trigger is some market value-based measure, then there is some chance that it could work. If the trigger is something like that in the Lloyds situation, which is dependent upon some book value /regulatory capital measure, then I don't think it has a prayer of being effective because politics will come into play.

The IRA: You raise the age old question of separating economics from politics.

Eisenbeis: I think that is exactly right.

The IRA: David, what do bond holders think about CoCo bonds and the discussion of contingent capital more broadly? Are regulators and their political masters offering solutions or creating new problems?

Kotok: Bond holders find themselves in an uncomfortable place. They like the distinction between the equity side of the balance sheet, which is where the preferred classes reside, and the debt side of the balance sheet as long as that debt is paid. The subordinated debt holders of the GSEs went through a worry period but then a line was drawn so that they are on the protected side of the balance sheet. The preferred holders of the GSEs got killed and that included banks which owned those preferred as part of their capital structure. Now what bond holders say today is now how can I be so sure? Bond holders will start to look for compensation for what they see to be rising risk. This gets worse when you introduce this concept of the convertible bond or CoCo instrument. The market will price the convertible bond. It will assess a risk premium. The market now must add to the business risk of the issuer something I would describe as government policy risk or, if you are impolite, government policy run amok risk. What will that interest rate be? If that interest rate truly reflects the risk, will the cost to the issuer be so high as to make this type of debt unproductive?

The IRA: It seems to us that the discussion of CoCo bonds is really about repudiating the doctrine of TBTF and this means repudiating the implicit state guarantee to bond holders of large banks. So wasn't bank debt always too cheap? Like Fannie Mae and Freddie Mac, were not investors always free riding on the public credit when they purchased the debt of complex universal banks?

Kotok: Well, we don't know! The big issue for investors today is and for us at Cumberland is that when we look at the indices that Bloomberg collects on banking holding company debt and we look out on the yield curve past two or three years, what we find is that the interest rates have not declined very much. Those yield spreads on bank holding company debt are still extremely wide. The other day in our shop we did a secondary market trade in Wells Fargo paper, 8

½% yield, 17 years to maturity. Now 8 ½% yield on 17 years for WFC is probably +300 bp to similarly rated corporates that are industrial companies.

The IRA: That is because the corporate sector is still solvent whereas the banks are not. One of the idiocies of recent Washington history was not repealing the Bank Holding Company Act when we did away with Glass Steagall. Today the banking industry is a government-protected monopoly with no capital - except from the government. Non-banks and private equity are locked out. Your description of the cost of debt for large bank holding companies also explains why they cannot raise new equity capital in meaningful amounts without government support.

Kotok: Going back to Bob's point, today market based pricing is telling you that sure, for the next year or two we have this notion of TBTF. But after that, who knows. We have all of this application of the federal guarantee, FDIC-insured notes and so forth. But beyond that we don't have a clue as to what is going to evolve here. Policy making has been so haphazard and uncertain and of questionable transparency, we have no basis to develop a projection. So long as WFC has to pay 8 ½% for money, what does it have to get in the redeployment of that money in order to be profitable?

The IRA: Precisely. And we are not even talking about the WFC off-balance sheet exposures, although perhaps the bond market spreads do reflect the uncertainty in that regard.

Kotok: Well, the bottom line is that the policies that we see including this new instrument and the other, what I call "wiz kid" ideas like the $1 trillion PPIP which is a fizzle, they do not create confidence. These polices inspire distrust and undermine confidence number two. And thirdly they are not solving basic issues with banks and markets that Bob has been describing in our comments over the past many months, chiefly the difference between solvency and liquidity. Some people in the Treasury do not understand the difference or they do not want to.

The IRA: In most cases we'd guess that they do not want to. The political implications of ending America's addiction to debt and inflation, an addiction that goes back to the Civil War and was only temporarily interrupted by WW I & II and the Cold War, are too horrifying for our cowardly political class. Or as Ed Kane likes to say, the convenience of regulators is a vastly under-appreciated factor behind TBTF.

Eisenbeis: Another dimension to the issue that David raises is transparency. There has been no discussion at all about how one unwinds the series of ad hoc guarantees and the debt guarantees…

The IRA: And the "temporary" repurchase agreements between the Fed and the large dealers.

Eisenbeis: Yes. There has been no discussion of an exit strategy from any of these government guarantees.

The IRA: Bob, in your comment you talk about the supposed CoCo bonds as a partial or contingent liquidation for a bank. Don't you think that this is really the point; that we should stop talking about suddenly liquidating large banks and that instead we need to provide a transparent mechanism for funding them when they take large losses and need to de-lever in an orderly way?

Eisenbeis: There is this fundamental misunderstanding that just because a financial institution fails does not mean that it disappears. Airlines in bankruptcy have continued flying and not been liquidated time and again…

The IRA: What a flattering comparison…

Eisenbeis: If the concern is about risk, why do people seem so willing to travel on bankrupt airlines? People assume that the company will keep running. with the concept behind CoCo bonds is to enable a bank to de-lever and keep on going without a liquidation. That was one of Mark Flannery's basic ideas in his paper, "No Pain No Gain," which we wrote about last week. The idea is to be a phased de-levering, but that does not seem to be happening in the Lloyds case. Under Flannery's concept, the de-levering of the enterprise was supposed to include write-downs of assets while the conversion of debt occurred, so that the bank would shrink significantly. The Lloyds model seems to be a means for the bank to continue on a levered basis without any realized losses. The idea of recapitalizing the institution seems to have gotten lost in the conversation.

The IRA: So what about this surprises you? There are few willing sellers of assets on Wall Street or in the City of London. Just watch how the creditors of Dubai will now clamor for a debt exchange to avoid realizing losses on this monument to excessive leverage.

Eisenbeis: The other point made by Flannery that is lost in the Lloyds case is the mechanism for conversion. Flannery envisioned a re-issuance of securities upon conversion to replace the securities. But what about the actual mechanics of conversion? How do you share the losses with different classes of security holders? Does everyone share equally or do we assess losses sequentially?

Kotok: You know, in a strange way the Dubai Islamic bonds may become a test case for this cockamamie CoCo proposal of distinguishing between debt and equity. Under English law the interest payment from Dubai World is due and it will be a item of default if they fail to pay. Under Islamic law these are equity interests so the technical form is a distribution of a profit which is not there; hence, no payment is required. The bond indenture says this debt instrument is under English law. But the adjudication of any dispute will be under Islamic law. The market is assuming that the Abu Dhabi Investment fund will bail out the bond. I am not so sure. If they do, they open up an Islamic version of a moral hazard expansion. That is why I think there is a possible contagion risk and that this problem potentially is much larger than a single payment on a $3.5 billion item. Markets are only looking a the outstanding Islamic bonds that have been issued. The amount of bank loans in this form is unknown and transparency will not be available until reporting bank have to disclose their exposure. I digressed a little from the US situation. Sorry.

The IRA: Digress away. That's okay given the news. There is no transparency in the EU either when it comes to bank financial disclosure, so let's not beat up on the Arabs overmuch. It's not like people did not know that Dubai was making aggressive use of debt to fund its development. So, if we see CoCo bonds in the US, who takes the first loss? In the case of equity, would it not have to be pro-rata to meet the basic test of fairness in the US law? What about this David? Should regulators demand a set schedule for the assessment of loss against equity holders based on a first-in, first-out type arrangement? A living will?

Kotok: Sure, the more clarity you bring to the situation, the better. My issues as a bond buyer and money manager start with how clear are you as to the claim you have to secure you as a bond holder? What is the priority of these claims? What are the event risks that can undermine them? And can I then price the various options in these instruments? A bond indenture is an articulation of a bunch of options. That's what it is in simple terms. If you have all of those elements and they are clear, then you make an assessment of risk and you come up with a price. Everyone else in the market does the same and you have a consensus about valuation. That is a mechanism we are used to. But when you add to this calculus the government event risk that comes from inconsistent policy making, you up the ante enormously.

The IRA: So you believe that the still wide spreads on financials beyond short-term yields reflects uncertainty about the Congress, the Fed and policy making in general?

Kotok: Yes, I believe so. And I believe that government event risk is an infectious element and that is why it is reflected going out the yield curve with a very large risk premium reflected in market prices for bank debt. The reason for this risk premium is that the markets are, in effect., saying that we have seen intervention established for a short period of time. We've defined it in the FDIC when it comes to bank deposit guarantees expiring in 2013. We've defined it in a new regime for guarantees for bank debt set by the FDIC that are so onerous than nobody wants to participate unless they are desperate for funds like GMAC.

The IRA: Careful David, some of our former colleagues from Bear, Stearns are building a bond arbitrage desk at GMAC. This is what the Obama Administration calls "green shoots." Of interest, GMAC's bank unit, now called Ally Bank, rates an "F" as of Q3 2009 from The IRA Bank Monitor.

Kotok: In the end, the market is saying that for the next two years we are not too worried about banks. Through the 2012 election, the majority in the Congress and the President will be the people who have brought us these programs to stabilize the banks. In 2013, this could all change. We have GSEs that are still operating in the markets on an implied guarantee from Treasury because Treasury will not take the GSE debt explicitly on its balance sheet. On the way back from Tokyo last week, I sat next to a guy who is running the agency desk at one of the largest primary dealers. He described to me the road show he was on to sell US agency paper to Asian financial institutions. We talked about this approach. He said very bluntly that the Asian banks are not buying it. He told me that "we have destroyed confidence and they do not trust us." My response to this was "do you blame them?" We then talked about the failure of US policy to date and he confirmed my view, that I talk about in my upcoming book, which is that Washington has largely destroyed confidence in the United States of America among global investors. So when we introduce new cockamamie schemes like CoCo bonds to go along with the existing cockamamie schemes such as those we already have, we only make matters worse.

The IRA: Well, when we were on *Bloomberg Radio* with Josh Rosner on Tuesday, he leaned over to me during a break and predicted that the Obama Administration was preparing to impose a VAT on the US and will use the supposed pressure from our aggrieved allies and global investors as the pretext. We later spoke to our friends in the conservative movement and it turns out that Brookings Institution has been working night and day on a study that will be the road map for implementing a VAT. This is to be a nation-wide sales tax on the American people to pay for the bank bailout. Apparently Bob Rubin and Larry Summers are the proponents of the VAT and they are planning to use the apparent pressure from our foreign creditors as the justification for a large, permanent increase in taxes. And David, you just described the failure of an auction of agency debt that could provide the pretext for just such a move.

Kotok: Joe Mason and I have had this conversation. Bob and I have had this conversation. The failed auction has not happened yet. It may not happen. But it would not surprise any of us if it eventually does happen. I expect a VAT to be introduced. I expect it to be introduced during the lame duck session of Congress in 2012.

The IRA: You think we can hold it off for that long?

Kotok: Yes. To introduce it sooner is a huge political risk to the Democrats. Obama & Co has lost an enormous amount of support. If Obama introduces a VAT reluctantly, as a last ditch effort to repair American credibility on fiscal issues as part of this re-election campaign, then it can work.

The IRA: So despite the weakness in the polls and the economy and double-digit unemployment pretty much a given as far as the eye can see, you believe

Obama can be re-elected? Is not America ready for Sarah Palin? Her book, Going Rogue, is generating some impressive traffic in the great media void.

Kotok: The Republicans are capable of establishing loss. They will do everything possible to avoid victory. They already have proven that time and again. If it is a Palin-Obama race, then Obama will be re-elected.

The IRA: With the economy likely to be still in the dolldroms by 2012, since we are unlike to grow at the 5-6% annual rates necessary to jobs for unemployed workers, that is a pretty stark indictment of the GOP. Bob?

Eisenbeis: To David's point about the uncertainty reflected in bond prices, with the crazy schemes for regulatory reform now being tossed around Washington and no discussion or vision as to how the competitive landscape in financial services will look several years out, it is no wonder we see longer term bond prices behaving the way they are. Not only do we have uncertainty reflected in bond risk premiums, but also bond investors don't have a clue about how the financial services industry will look. It's like Christopher Columbus sailing off for the New World with no idea as to the destination. No wonder uncertainty and bond yields are so high.

Kotok: And to Bob's point, nobody is even starting to talk about how we get back to a well-capitalized financial sector that can support risk or real economic growth. If you use the numbers from Jim Bianco's tally of about $1.8 trillion in losses, we have had capital raised of $1.6 trillion, but almost $600 billion of that is government money. So the private sector has come up with $1 trillion, but we are still $1 trillion short if you think of meeting the losses and actually increasing capital. And let's assume you could stop today and have no more losses, which is questionable since we all expect several hundred billion more in losses. Yet now we are imposing new regulatory structures, we manage compensation and we diminish the profitability of a business sector and add to its risk. And then we wonder why we do not get more private sector investment in financials.

The IRA: Well, as we have discussed many times, we are heading for a European model David. President Obama is an internationalist, he does not even begin to resemble an American socialist like Mark Pittman's hero Woody Guthrie. He is definitely in the one-world, Euro-centric model, as evidenced by the White House's open admiration for the Canadian and French banking systems.

Kotok: Correct. So what that says to me is that the wounded banking sector of the US is here for a very long time. You said it on the radio this week in terms of the 2,400 plus banks that are now rated "F" in your system, which is a quarter of the whole industry. You've said that something like half of the "F" banks will fail. So over the next five years or so, I see the US muddling along with more and more interventionist, cockamamie scheming power which, sadly in my view, is not just coming from the Treasury.

The IRA: It's worse than that David. It is pretty clear from the leaks that populate book's such as David Wessel's fine tome, In Fed We Trust, that the decision process at the Fed is entirely short-term and reactive. We could take some comfort were the players at Treasury or the Fed or even the White House really purposeful, ideological socialists. But instead we have a group or politicians who collectively are almost entirely ignorant of American history or economics making structural decisions about the US economy based entirely on today's crisis or expediency. Is that unfair?

Kotok: No, I would not argue with that.

Eisenbeis: There is no question that we are trapped in a short-term mindset. When you see all of these excuses from the Fed reflected in Wessel's book how "they did not have time," well yes they did. We still have time to look at these issues and make deliberate choices. When you are not playing with your own money, you don't have incentives to plan for the future. It is interesting that Congress feels the need to rush to reform the financial system, but the Fed found it necessary to bow to congressional pressure to postpone dealing with internet gambling on the grounds that more time was needed to carefully consider the issues.

The IRA: Well, most of the money we are talking about is borrowed from our foreign creditors, so perhaps that is the answer. And yes we did notice Rep. Barney Frank (D-MA) taking a victory lap for derailing the new limits on Internet gambling. Maybe now we know who pulls Barney's strings. Thank you gentlemen.

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