

Memo to: Oaktree Clients

From: Howard Marks

Re: Plan B

Over the last decade or two, Plan A consisted of relying on the free market to maximize economic growth and efficiency (as described in “The Aviary,” May 2008). What can we say about that? Oops? We don’t hear much at this moment about market efficiency, or about the proposition that it would cause complex mortgage-backed securities to be priced right.

So now we have Plan B, better known as TARP, the Troubled Asset Relief Program. On the heels of other injections of capital by the U.S. Treasury and Fed and central banks elsewhere, it was proposed on Friday that up to \$700 billion be spent to purchase “toxic” mortgage securities from financial institutions that are weighed down with them.

Ya’ Gotta Believe

Those who have more money than they need lend it to those with use for more money than they have. This process is called providing credit. The movement of credit puts otherwise-idle money to work and thus adds to economic output. Economies run on credit.

According to Merriam-Webster, the word “credit” is derived from the Latin *credere*: “to believe, entrust.” We provide credit when we believe in borrowers and trust that they’ll pay us back (although we believe in some more than others and charge the latter more interest). Further, the entire economy runs on trust: that the people to whom we provide goods and services will pay their bills; that contracts will be adhered to; and that money will retain value, or at least the part that inflation doesn’t erode.

Belief is what makes the economic world go round. Take a minute to think about how we would behave in a world in which there wasn’t trust in money, the institutions that store it and the mechanisms that move it from one place to another. Clearly, we’d be sunk without trust in the financial system.

I’ve described in the past how financial institutions are vulnerable to loss of faith because of their unique combination of opacity, leverage, conscious risk bearing, and their use of short-term deposits and borrowings to fund longer-term, illiquid assets. When providers of capital lose faith in a financial institution, they line up to withdraw their money. But the institution can’t give them all back their money, because it can’t liquify all of its assets immediately. Attempts to do so increase the downward

pressure on asset prices, further weakening financial positions and reinforcing the loss of faith. And thus the circle becomes vicious and we have a “run on the bank.”

We saw many runs on banks during the Great Depression; the result was the introduction of federal deposit insurance. We also saw a bank run in the U.K. last year, when depositors lined up at the Northern Rock building society until the Bank of England calmed fears by guaranteeing all deposits. (I had money there, and believe me, absent the guarantee, the 2% penalty for early withdrawals would have been powerless to dissuade me from moving the remaining 98% to a safer institution. Take a few hundred or thousand of me, and you have a run on the bank.)

In short, the government is attempting to prevent a loss of belief. Is such a thing possible? Ask yourself whether eight months ago you thought possible this year’s developments at Bear Stearns, IndyMac, Lehman Brothers, AIG, Fannie Mae and Freddie Mac. To some extent, they all stemmed from a loss of faith.

The Source of the Problem

There are two principal fundamental causes behind the events we’re seeing. The first is the huge losses in complex mortgage-backed securities. As I’ve written before, the issuance and purchase of these securities resulted from the following confluence of factors:

- Quest for return, decline in risk aversion and lowering of skepticism.
- A boom in home prices and a belief that they couldn’t fall back *en masse*.
- Securitization and selling onward of debt – which eliminated lenders’ hesitance to lend and led to a process in which everyone profited when a loan was made.
- Thus an increased willingness to lend higher percentages of the skyrocketing prices of homes, even where the borrower couldn’t demonstrate creditworthiness.
- Widespread use of leverage (because the risks were underrated) and complexity in fashioning mortgage-backed securities.
- Massive shortcomings at rating agencies that erroneously described the resulting securities as investment grade, and sometimes even “super senior.”

In this way, enormous amounts of overrated securities came to the market. They went to financial institutions that didn’t understand the riskiness of what they were buying and thus permitted themselves to become vastly overleveraged.

I’ll keep it simple. Suppose you have \$1 million in equity capital. You borrow \$29 million and buy \$30 million of mortgage loans. Twenty percent (or \$6 million) of the mortgages go into default, and the recovery on them turns out to be only two-thirds (\$4 million). Thus you’ve lost \$2 million . . . your equity capital twice over. Now you have equity capital of minus \$1 million, with assets of \$28 million and debt of \$29 million. Everyone realizes that there’ll be nothing left for the people who’re last in line to withdraw their money, so there’s a run on the bank. And you slide into bankruptcy.

Because of the high regard in which financial institutions were held; because of the implied government backing of Fannie Mae and Freddie Mac; and because permissible leverage increased over time, financial institutions' equity capital was permitted to become highly inadequate given the riskiness of the assets they held. Or perhaps I should say institutions took on too many risky assets given the limitations of their equity capital. That, in a nutshell, is why institutions have disappeared.

The second fundamental factor leading up to the current mess was the creation of the vast market in derivatives, especially credit default swaps (CDS). In the current decade, CDS came into broad use as a mechanism for insuring against defaults. For an up-front fee and an annual premium, holders of debt could get someone else to promise that they'd buy that debt at face value in the case of a default or other "credit event."

The buyers of CDS accepted at face value that the writers of the insurance would pay if there was a default. For this reason, because Bank A had bought insurance on Company X's debt from Hedge Fund B, it considered it safe to sell insurance to Bank C. **But what if X defaults and A has to pay C but can't collect from B?** There's over \$60 trillion of CDS outstanding, and a lot of it is well hedged in theory; thus the net exposure to defaults if everyone pays might be rather small. But if some counterparties are unable to pay, institutions that bought insurance from them (or from others that bought from those institutions) might fail to receive billions in payments. Consider it one big daisy chain. It's probably because of its position as a counterparty that Bear Stearns wasn't permitted to fail in March (while Lehman was cut adrift this month when its failure was judged to be bearable).

Of course, these two developments have been complicated by (a) the fact that no one can reasonably say what the home underlying a mortgage is worth (the intrinsic value of a non-cash-producing asset is a useless concept in the short run), (b) the fact that no one knows how the credit swap market will function in a crisis, and (c) their own sheer magnitude. The sum of the foregoing has the potential to place in jeopardy any financial institution that lacks federal backing. It's for this reason that the government has assumed the liabilities of Fannie Mae and Freddie Mac, lent money to AIG, accepted Goldman Sachs and Morgan Stanley as bank holding companies (with permanent access to Fed borrowings), backstopped money market funds, and now proposes to purchase \$700 billion of mortgage securities.

Does Ben Know Something We Don't?

I cited the above headline in "Now What?" last January. That's what *breakingviews.com* asked about the Fed's September 2007 decision to cut rates by 50 basis points rather than the expected 25. Clearly Fed Chairman Ben Bernanke thought the circumstances called for stronger medicine than most observers.

Now it's clear that both Bernanke and Treasury Secretary Hank Paulson envision possible consequences justifying the strongest possible action. Last weekend, for example, Paulson said in an interview, "I don't like the fact that we have to do this. I hate the fact that we have to do it. **But it's better than the alternative.**" (Emphasis added)

What is the alternative? As I suggested last week in "Nobody Knows," there really is no outcome so negative that it can't be imagined. That doesn't mean terrible things will happen if no action is taken, but the possibilities are there, causing fear. Obviously, Bernanke and Paulson feel some of them could come to pass, and I respect their opinion.

So what is that alternative Paulson alludes to? Cascading bank failures? Interlocking dependence on counterparties in the derivatives markets who lack the ability to make good on their liabilities? Ultimately, reduced faith in U.S. Treasury securities and the dollar? As I said last week, I don't know. But it's not unreasonable to respect these possibilities. Our leaders want to justify the strongest action in history without spooking the market by enumerating the possibilities, so they're not being too specific. The Great Depression is our only model. I believe it justifies strong action.

Let me take a moment to say we're enormously lucky to have the right team in place at this time. Bernanke is a highly respected academic expert on the Great Depression, and Paulson is the very successful practitioner who chaired Goldman Sachs, an institution for which I have enormous respect. Being human, they're unlikely to get it all right. But I can't think of anyone I'd rather have in their jobs.

The Plan and the Stumbling Blocks

The plan is simple. In fact, to some it's too un-bureaucratic to be acceptable. The Treasury will use up to \$700 billion to purchase the most toxic mortgage-backed securities from financial institutions – both U.S. and foreign – that do business in the U.S. This will reduce the doubt about the institutions' solvency and, in place of unsalable assets, give them cash they can lend. No external oversight or internal process is specified, and the result will be immune from examination by other authorities and from litigation.

Having described the plan in one paragraph, it'll take much more space to discuss the complaints being voiced and the obstacles in its path.

- We're asked to trust the judgment and integrity of the Treasury Department. I find this a pragmatic and direct solution. Others more skeptical than me disagree. Some think Paulson will be biased in favor of Goldman Sachs and the rest of Wall Street, but I'm convinced he took the job out of *noblesse oblige* – not for money or fun, I think – and I trust him to do his level best.

On that subject, let me share a little history. Fifteen years ago, the staff of the Resolution Trust Company asked if we could help them achieve fair prices in disposing of the assets they'd taken on from failed S&Ls. I outlined a plan under which brokers would be asked for bids and we would watch the brokers, judging the adequacy of those bids. **"But who'll watch you," they asked.** My reply: "I've got bad news: you're going to have to trust someone." I'm perfectly happy trusting the Paulson-led Treasury.

- In a similar vein, some are complaining about the lack of supervision in the plan. The *Financial Times* quoted Barack Obama as saying, "We cannot give a blank check to Washington with no oversight or accountability . . ." Well, for my part, I'd rather entrust power to one wise man than a committee or bureaucracy consisting of average people. I think Paulson is that one wise man, but I'm also sure he's smart enough to surround himself with others who are equally capable.
- What will the marching orders be? In particular, what sort of prices will be paid? Fair market prices or higher? First of all, it's almost impossible to come up with a fair or "market" price for many of these assets today. Second, paying just the market price in the current highly depressed market wouldn't do much for the institutions' net capital position. But third, if more than the market price is paid, that'll be seen as a "giveaway to Wall Street." **It has to be made explicit – to those expected to approve the plan, and certainly to those expected to carry it out – whether these will be straight sales at market or they'll include a subsidy.** I think a bunch of the latter is called for.
- **Even beyond the points listed above, another issue may present a bigger stumbling block. The greatest reluctance may relate to the fact that, under the plan, when the process restores the viability of institutions that now are burdened with negative book value and inadequate confidence, the immediate financial benefits would go to shareholders and executives who either participated in the creation of the problem or, at any rate, should be penalized for the companies' failings.**

To solve the problem, some say that in exchange for taking securities off institutions' hands – especially at above-market prices – the government should get ownership positions in those institutions. But how much? What would be the proper *quid pro quo*? If a \$1 billion purchase of debt at \$200 million above market saved a \$15 billion institution, what piece of the company should the government receive? Do we want the government owning large pieces of private companies, or running them? And would that ownership stake then put the government in a conflict position vis-à-vis the institutions where it's not an owner? This is obviously a complex issue, and I'd hate to see it delay the solution of the problems we face.

Further, there are calls for requiring executives at the institutions involved to accept limits on their compensation. What could be worse than setting up reasons for people to hesitate before reaching for this lifeline?

- Certainly politics will be a major factor in whether the plan is enacted and in what form. In that regard, **there couldn't be a worse time for this to be debated than six weeks before the election.**

After being well ahead in the polls until late August, Barack Obama lost his lead when the Republicans held their convention and made Sarah Palin their vice presidential candidate. But last week, when the economic crisis exploded and John McCain described the economy as strong, the Democrats pulled back into the lead. That's not lost on them, and I'm sure they'll continue to use the issue to maximum advantage. They'll complain about the one-sidedness of the Wall Street bailout and demand something for "the rest of us," like further economic stimulus, direct relief for mortgage borrowers, and loans to the auto makers. This politicizing might delay the process, encumber it with baggage, or make it unattractive to its supporters.

Democrats will attack the plan to make Republicans look bad, and conservative Republicans may resist it as an unwarranted extension of the government's reach. In the end I feel it'll pass, but who knows in what form.

I don't view the plan as mainly a bailout for Wall Street and fat cats. Saving the financial system will benefit all users of capital, including home buyers and auto makers. Of course, that may sound like "trickle-down economics," which some are happy to rail against.

I think federal ownership would be a very hairy matter. But in this case I do have a solution, at least regarding the prices at which the government resells the debt: **Why not simply say that the government should receive half of the buyers' return in excess of a 20% yearly rate,** or some such? Ownership would present challenges, but sharing in the benefit would not.

Who's In the Wrong?

There'll be cries for scalps, and politicians will play to the crowd by assigning blame. This should be primarily a side-show, but it can grow into a significant distraction.

Short sellers are in the crosshairs most prominently. It is a simple fact that ever since the up-tick rule was revoked fourteen months ago, short sellers have had the ability to drive down stock prices, which they couldn't do if a short sale could only take place at a price higher than the last trade. It's also a fact that some financial stocks have fallen, and that their declines have added to worries about the companies, inducing further declines. Of course, no connection between the two has yet been proved.

As a result of the recent market action, short selling was outlawed in roughly 800 financial stocks, including outliers such as General Electric. This action was coincident with last Friday's rally, and people breathed a sigh of relief. Had short sellers been

responsible for the demise of Lehman? Should short selling be banned? As usual, the answer isn't clear.

Balancing out the simple truths stated above, a number of factors argue in favor of short selling or against a ban:

- Short selling isn't "worse" than outright buying. One makes stocks go down; the other makes them go up. Why is shorting – selling what you don't own – any worse than buying what you don't own?
- Short selling is a highly legitimate way for investors to act on their belief that a stock's price is too high. Thus it tends to help stocks sell at fair prices.
- Short selling can bring losses to those who hold stock, but unabated buying can force stock prices to too-high levels where no one should buy. What can we do to prevent injury from purchases during unjustified booms?
- **Sure you can keep stock prices from being forced down by outlawing short selling. But then why not outlaw all selling? Think of what that would do for stock prices!**

In the short run, protecting the financial system is more important than preserving market efficiency or heeding the above arguments. Thus I do not think it was a mistake to ban short selling for the time being.

In the long run, however, I feel a ban on short selling is not in order, although I consider it desirable for the up-tick rule to be brought back.

Finally, as with many other things, the real problem isn't with short selling, but with abusive short selling. Manipulating the market to make short positions profitable by spreading negative rumors or bidding up CDS (see "Nobody Knows" from last week) should be driven out . . . although doing so won't be easy.

* * *

The trouble with memo writing at times like these is that there's always more. But this is a good time to wrap up regarding the Treasury's plan. My conclusions are as follows:

In the period 2003-07, the government, and especially the Fed, stimulated the economy and the financial system when they should have been acting restrictively to curb excesses. On the contrary, stimulation is in order today to prevent serious damage. I think we're going to get it.

But I also expect to see a rising tide of regulation of financial institutions in the period ahead, and I don't think restrictiveness will be the right thing until the system is on a firm footing. It's widely agreed that the authorities contributed to the severity of the

Depression by withdrawing liquidity when they should have been increasing it. Let's not tighten again.

In "Doesn't Make Sense" in July, I listed four things that have to happen in order for the trends in mortgages and financial institutions to turn positive:

- Home prices have to stop going down.
- Home mortgages have to be made available.
- Financial institutions have to stop experiencing incremental write-offs.
- Financial institutions have to be able to raise additional capital with which to rebuild their balance sheets.

I also pointed to the complication: that each of these four things is dependent on the occurrence of another. **The good news is that the Treasury plan has the potential to break into the cycle of negativity, directly address the third and fourth of these, and thus contribute to the first and second. That's why I'm all for it.**

In the Depression, the engine of capital provision went into a long-term stall, and we know the consequences. The attempt now is to jump-start processes that have stalled and prevent the rest from doing so. I'm sure this is the right thing to do, and I hope for its success.

September 24, 2008

P.s., In "You Can't Predict. You Can Prepare." (November 2001), I described the process through which stock markets pull out of declines and turn upward:

Stocks are cheapest when everything looks grim. The depressing outlook keeps them there, and only a few astute and daring bargain hunters are willing to take new positions. Maybe their buying attracts some attention, or maybe the outlook turns a little less depressing, but for one reason or another, the market starts moving up.

In the latest development, it was announced yesterday that Berkshire Hathaway would invest \$5 billion in Goldman Sachs stock. Warren Buffett exemplifies the kind of person who can step out of the crowd. **Perhaps his example can make a few more people stop worrying about losing money and start worrying about missing out on gains.** One of these days, that'll happen, and things will turn for the better.