

“THE TIMES THEY ARE A-CHANGIN’,” WHAT NOW?

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In September 2008, the financial market rollercoaster kicked up to a real “E” ticket ride with a set of stunning changes to the financial landscape. The September action started with the placement of Fannie Mae and Freddie Mac into conservatorship by FHFA. The weekend of September 13-14, Bank of America switched brides at the altar, exchanging Lehman Brothers for Merrill Lynch. A jilted Lehman Brothers promptly nose dived, taking its last gasps in a 158 plus year life as it headed into Chapter 11 bankruptcy liquidation. Barclays plc moved to purchase Lehman’s North American investment banking and trading operations as well as the New York headquarters building. American International Group, the American mega-insurer, requested and eventually received an \$85 billion credit facility from the Fed. The following weekend, both Morgan Stanley and Goldman Sachs, the last of the large investment banks, received permission from the Federal Reserve Board to become bank holding companies, accepting greater oversight in return for the access to more stable bank deposit capital. On September 25, Washington Mutual tanked and was driven into the arms of JP Morgan Chase. By September 29, the FDIC brokered a deal for Citibank to purchase a wounded Wachovia. As October began, the Administration’s proposed financial intervention, now in Plan B mode, was the subject of contentious debate, with the Dow and NASDAQ suffering historic losses.

So what? So what do all these machinations mean to governments and their citizens? First, they increase debt carry costs. The lack of liquidity has driven up variable rates of interest, for both auction certificates and variable rate demand obligations. These short-term high points currently exceed long term interest rates. Long-term rates for munis have increased while Treasury yields have decreased on the flight to “ultra” quality – while the traditional flight to quality includes both Treasuries and high grade munis, this flight stopped only at Treasuries and did not extend to munis. The increased perception of risk by the general investing public has resulted in increases in long term tax-exempt interest rates in the absence of any increase in long term Treasury security rates. Moreover, the costs of liquidity and credit support have multiplied and show little sign of moderation in the near future. With fewer participating banks, supply goes down and prices face upward pressure.

Second, in the long run, federal taxes seem likely to increase—at least over where they would have been absent the credit crisis. With a total national debt of about \$9.7 trillion, a bump of \$700 billion in one program from the proposed federal intervention has a real impact. Perhaps the federal government will recover a proportion of the investment, perhaps not. In the interim, the additional interest alone is in the tens of billions each year. Over time, the cost of the intervention has to be paid from somewhere.

Third, the relationship between governments and their investment banking firms may change in some subtle, but important, ways. With all major investment banks now regulated by the Fed as bank holding companies, they will face tighter constraints on the amount of leverage that they can apply to their businesses, including underwriting of securities. At this early point, we do not know how this might impact the actual distribution of bonds. There will be fewer national firms offering investment banking services. Moreover, we wonder whether the consolidation and changes in national firms will create opportunities available to be exploited by the more “regional” investment banking firms. A paradigm shift is underway. When Bob Dylan sang his protest song in 1963, America was being forever changed; the same is happening today.

What now? First, don’t panic - but don’t assume all the shoes have dropped. There may be more bad news. Second, remember that credit quality is even more important now (we said that in our last issue). Act accordingly by taking steps to effectively manage your finances and do a better job of communicating your situation to the market. Even in the recent “closed” market some transactions by issuers with good demographics and sound credit have closed. Finally, stay the course – if you are pulling together a financing, continue your plans. The market will continue to fluctuate and evolve for a time, and sticking to good fundamentals will be the best thing to respond to the changing times. ♦

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