

Concepts...

"Concepts" is published by Daedalus Oversight to raise as many questions as it answers. It is driven by the belief that the industry, its products and its services are ever evolving. The ideas reflect the challenges faced in the continuous journey of innovation and improvement.

De-Engineering Finance:

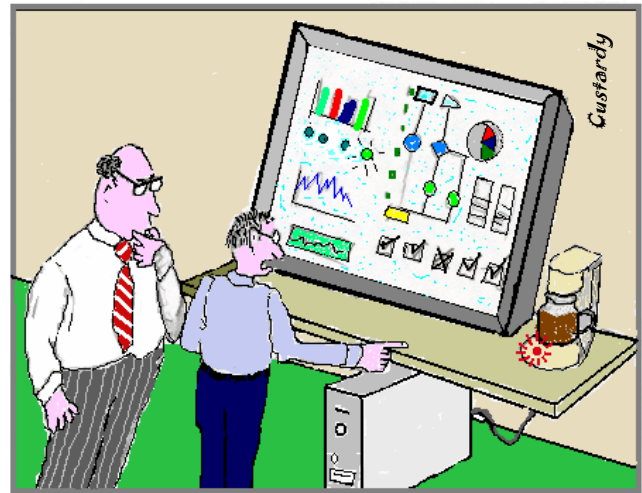
"Nowadays people can be divided into three classes -- the haves the have-nots and the have-not-paid-for-what-they-haves" - Earl Wilson.

The successful running of a company, bank, broker, investment fund, government or personal budget depends, ultimately, on being able to pay for things that haven't been paid for yet. In "Crisis in Finance" I discussed how the regulators, in their attempts to set standards to allow the sound management of financial companies, were working their way around the balance sheet. The necessity of this iterative development was caused by the failure of historical standards to identify or correct the highly leveraged and unstable balance sheets of Bear Stearns and Lehman.

The accounting standards had focused on capital (equity) as a protection proxy for leverage. Now the liquidity of securities held (assets) are being reviewed as an additional consideration. The next logical step is to consider the funding (liabilities). However, while there are easier, if not prudent, crisis-driven remedies for the first two, the third has to involve third parties. Capital (equity) can be injected and securities (assets) can be backed or sold under preferential repurchase agreements but funding (liabilities) has to be paid back to the lenders. In the absence of direct loan pay-downs, it is interesting that current policies now are including incentives for lenders to modify, defer or re-adjust loans to troubled parties. Is there an alternative solution to the crisis and a better tool to prevent it from happening again?

The counter-argument to the belief that a financial institution has the "problem of being too big to fail" is that it is a subjective assessment that allows the politicization of capitalism, which supports the wrongful idea of "failure being too big a problem". Capitalism is an efficient recycler of failure. Government intervention, however well intentioned, prevents failure and therefore the efficient recycling of poorly managed enterprises. Not only that, it co-opts other people's capital by tying it up as scaffolding, supporting ever weakening structures, while crowding out market supply.

In proactively reviewing companies, a stock analyst has many tools available to assess the status of Asset & Liability Management (ALM). However, these primarily deal with the trends for the liquidity (i.e. paying for anything now) and solvency (i.e. paying for things not-yet-paid-for). Another consideration should be that assets and liabilities match with respect to term. Just as well managed leverage can increase



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returns, greater terms for assets vs loans is commonplace for a viable ongoing enterprises. If there were a measure for the ratio of weighted average terms for assets vs liabilities, called, say, 'financing skew', it could be measured historically for companies able to weather downturns vs those that fail. The market could then set the standards for healthy 'financing skew' and value a company's equity accordingly. Highly leveraged companies can be successful and Lehman had the attraction of significant revenues and profits. However, compared to its peers, the higher ratio of long term assets supported by short term funding would have shown the 'skew' and vulnerability of Lehman's business.

The goal here should not be to put in place new blunt requirements. Government financial regulations have proven to be porous barriers weakened by the moral hazard of "failure being too big a problem". All the current Government solutions, described here, defer the problem of not paying for the things not-yet-paid-for. Ultimately they will have to be paid for and the 'skew' in the whole economy will be revealed.

Daedalus Oversight would be pleased to discuss the realization of these concepts with you further. We thank you for your consideration.

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