

***Six Things You Need to Know to Understand
the Nation's Financial Crisis and What We
Can Do to Survive It***

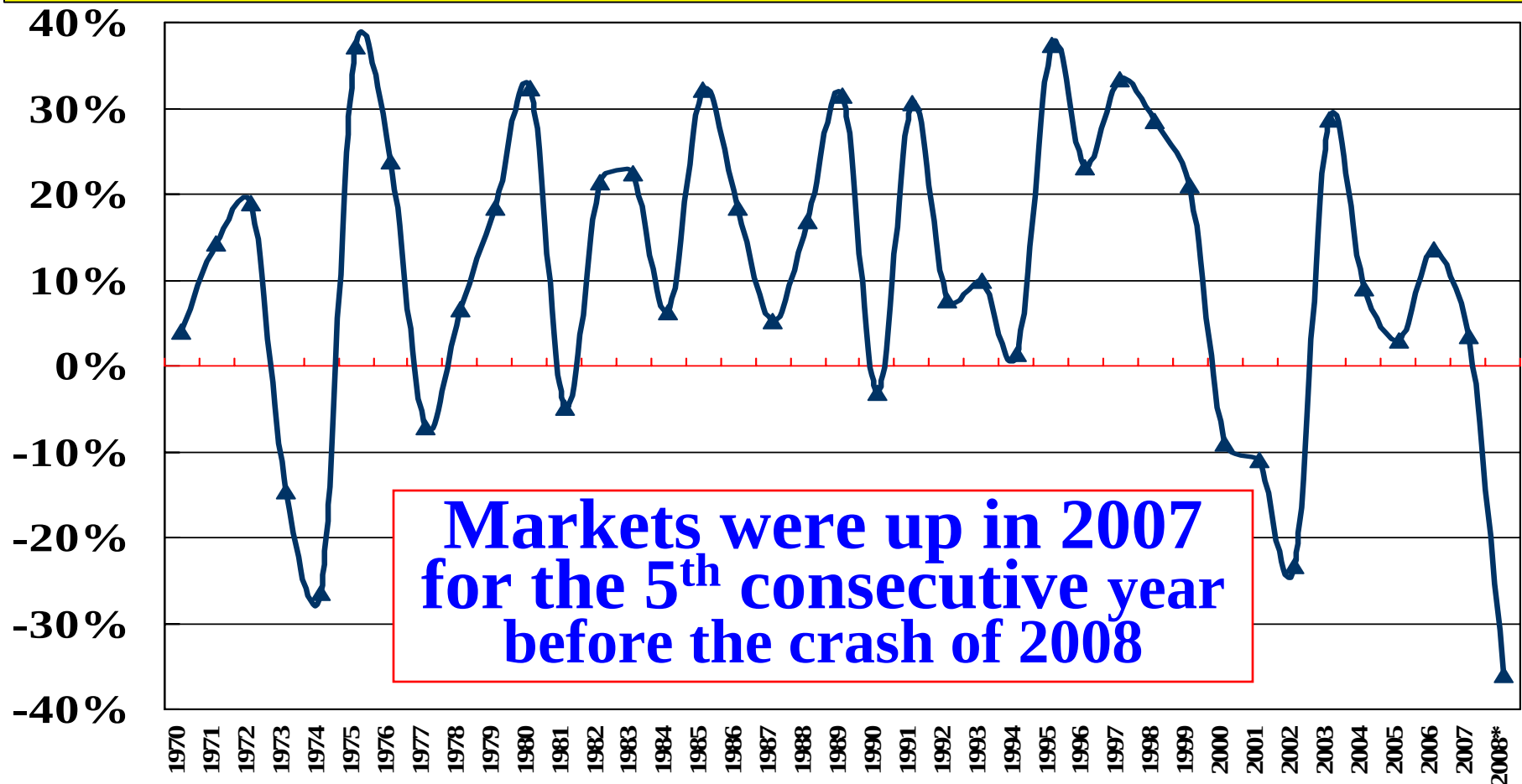
North Perimeter Chapter
Georgia Society of CPA's
March 17, 2009
Bill McDermott

Presentation Outline-The 6 Things

- We have \$20 trillion in the housing industry and in the stock market each. Both have declined leaving a lack of consumer confidence and are bleeding into the economy
- Real wage growth started to stagnate in 1999
- American households supplemented stagnant income with consumer debt
- We have had a decline in real GDP growth that started in 2006
- We consume about \$2 billion of goods per day more than we produce
- Use of derivatives, specifically, credit default swaps and asset back securities got out of control and the underlying risk was unmonitored

Total Returns for Large Company Stocks: 1970-2008*

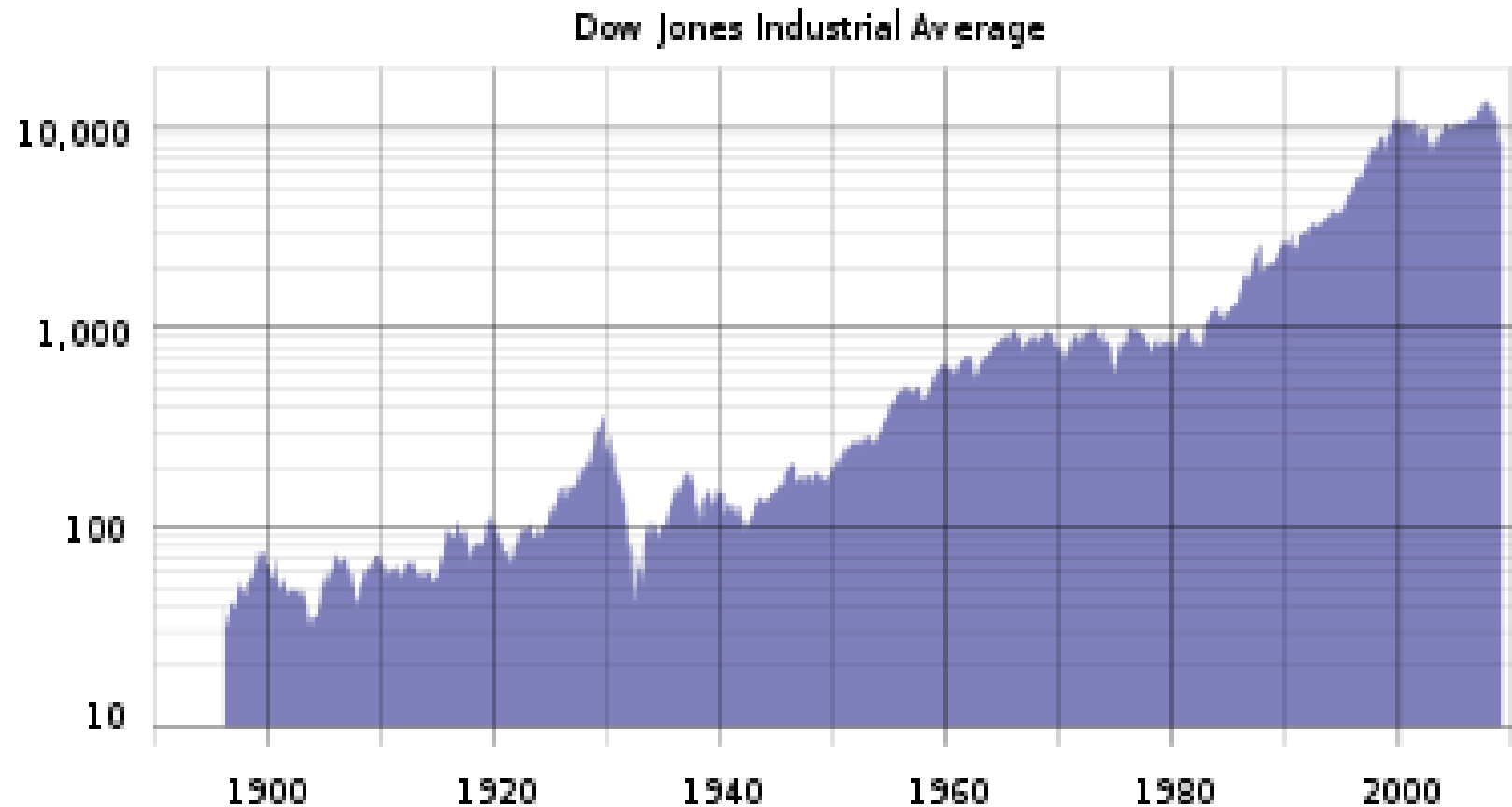
S&P 500 was up 3.53% in 2007, but down 36.0% so far in 2008*



Source: Ibbotson Associates, Insurance Information Institute.

*Through October 17, 2008.

History of the Dow from 1896 to December 2008



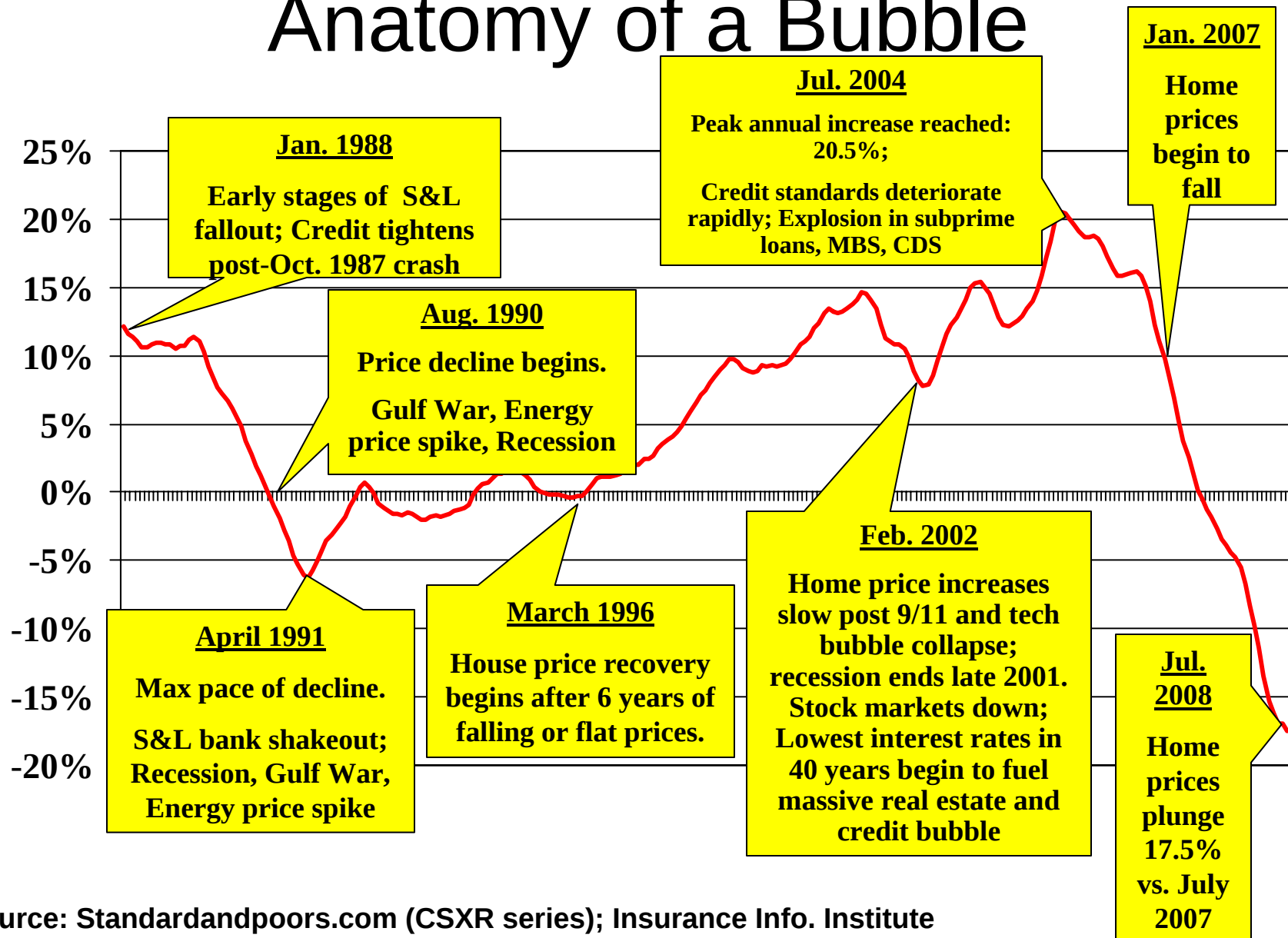
The housing industry...
More of the Same

The Housing Crash
**Collapse of the Home Price
Bubble**

What happened...

- In 1999, Fannie Mae, the nation's biggest underwriter of home mortgages, announced...
- The Clinton Administration pressured Fannie Mae to help working-class home buyers...
- The Bush administration called for the entire housing industry to help 5.5 million minority families to become homeowners...
- The entire lending industry was being pressured to ease up on lending requirements...

Home Price History: Anatomy of a Bubble



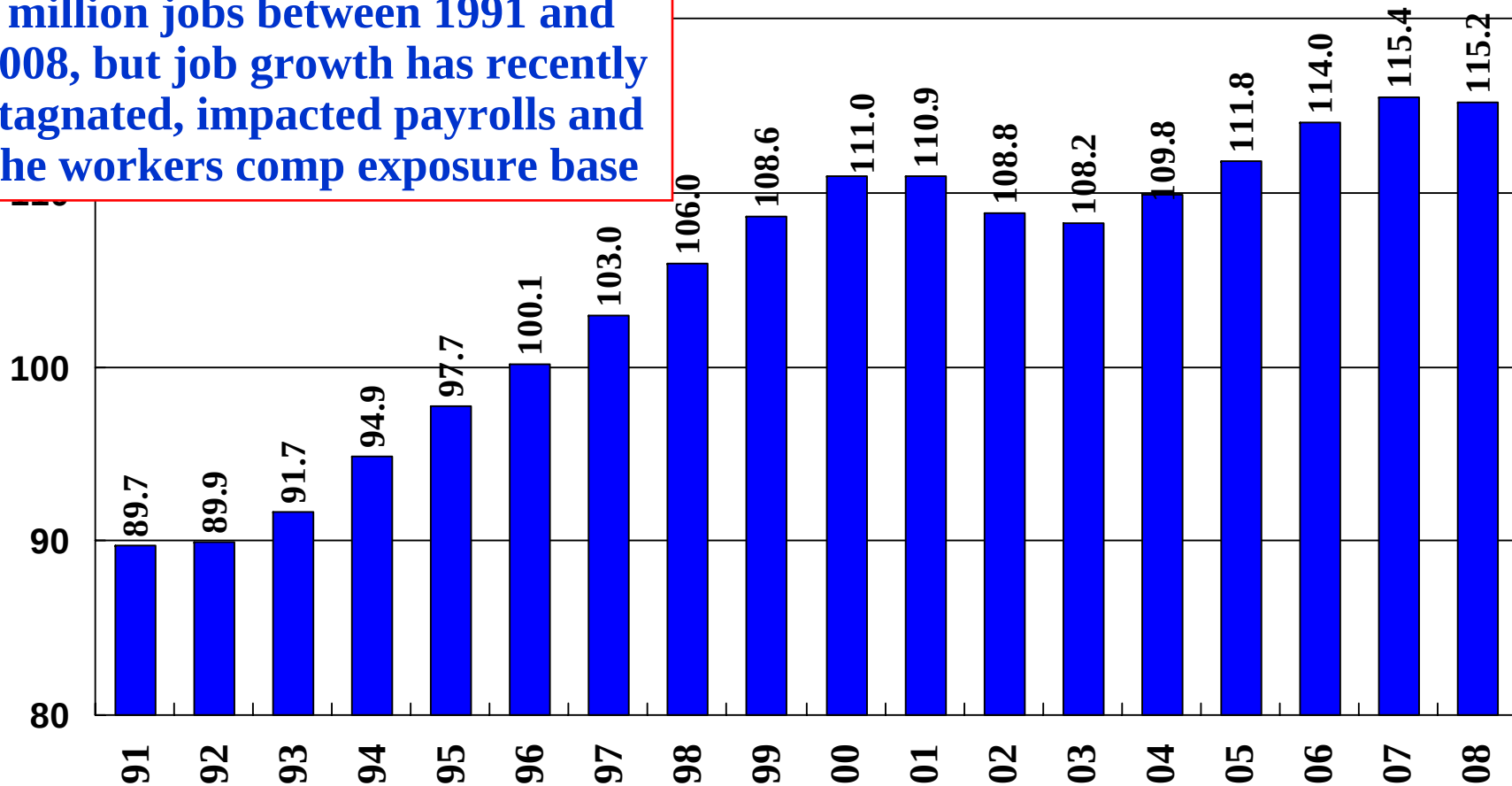
Source: Standardandpoors.com (CSXR series); Insurance Info. Institute

For the consumer...

- The combination of a significant decline in the stock market and the housing industry has left the consumer with significant decline in their net worth which has undermined much of their confidence about the future
- In some cases, a 50% drop in the value of their home and their retirement/investment portfolio

Total Private Employment* Grew by 25½ Million Workers from 1991 to 2008

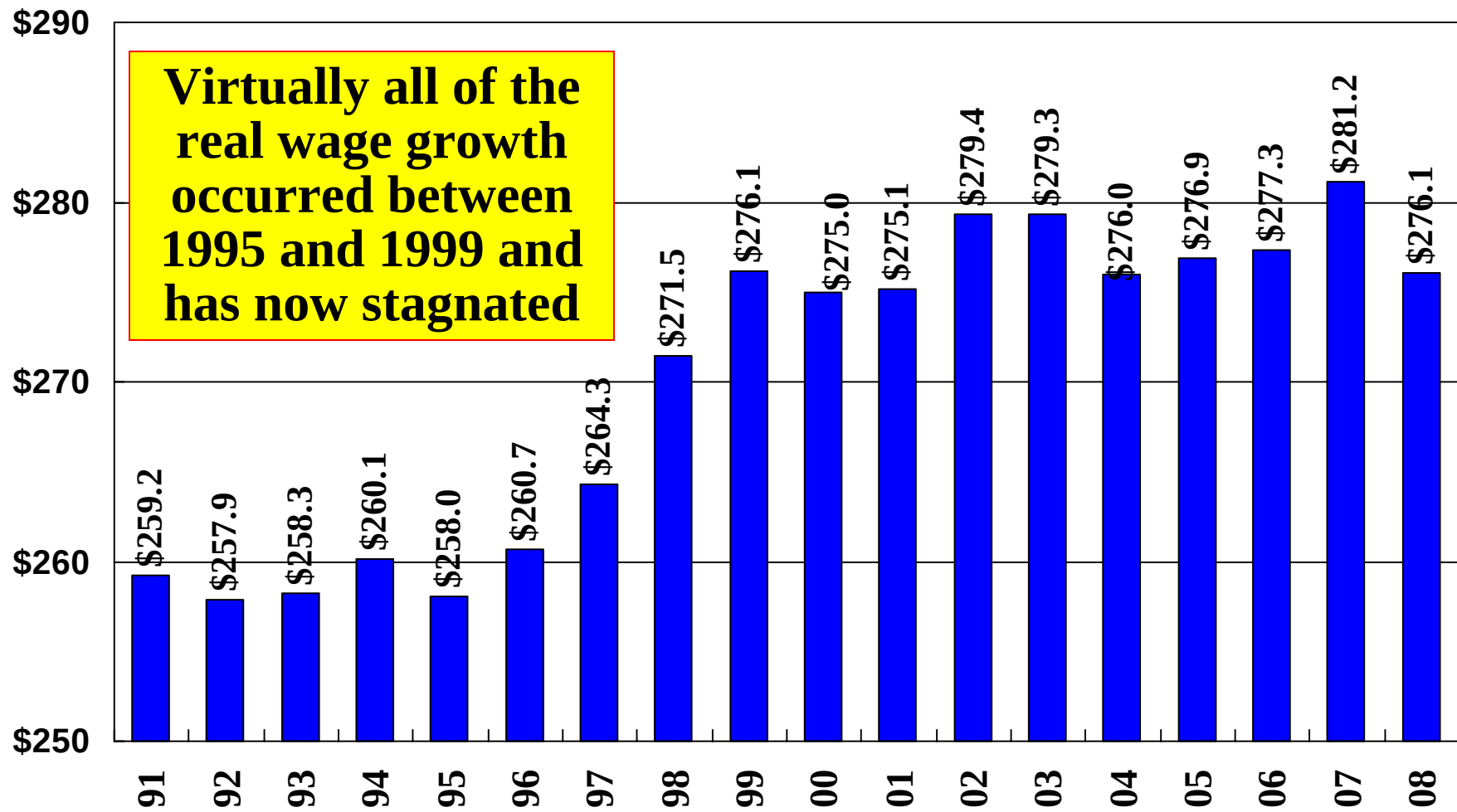
The US economy added 25.5 million jobs between 1991 and 2008, but job growth has recently stagnated, impacted payrolls and the workers comp exposure base



*seasonally adjusted at mid-year

Source: U.S. Bureau of Labor Statistics, at <http://data.bls.gov/cgi-bin/surveymost>

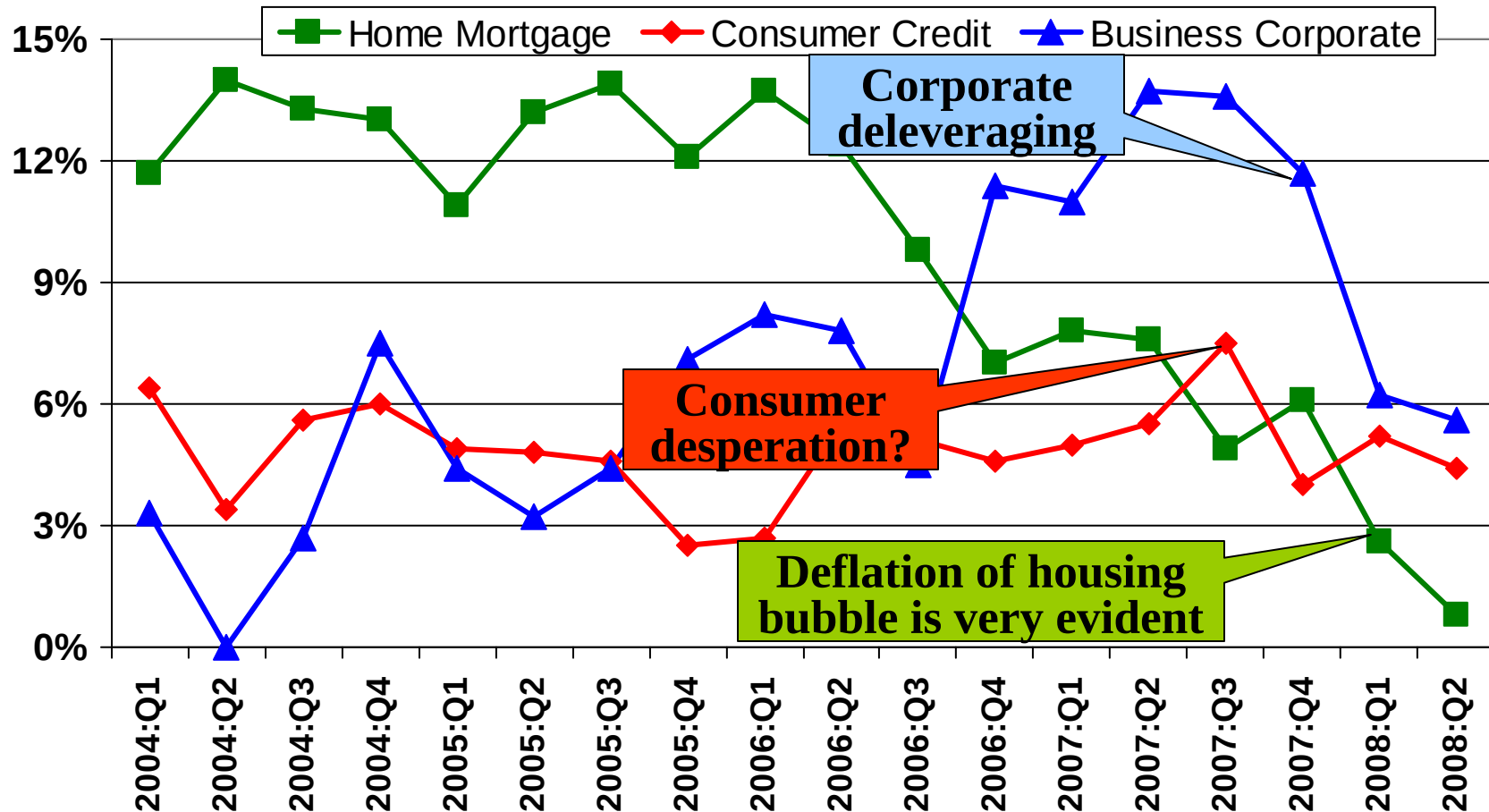
Average Weekly Real Earnings in Private Employment Were Flat from 1999 to 2008



Sources: U.S. Bureau of Labor Statistics; I.I.I.

Percent Change in Debt Growth

(Quarterly since 2004:Q1, at Annualized Rate)



We've become ...

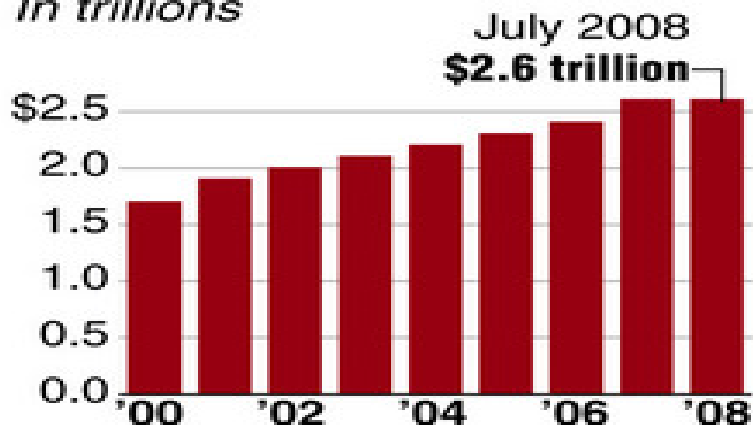
A nation of borrowers

Undisciplined borrowing has been identified as a major contributing factor to the current financial crisis.

U.S. consumers

Cumulative consumer credit,
as of December of previous
years and July of this year

In trillions

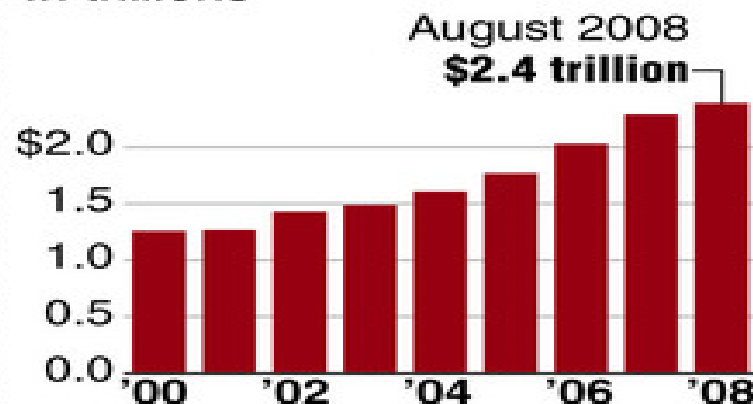


Source: U.S. Federal Reserve
Graphic: Pat Carr

U.S. financial institutions

Cumulative borrowing by U.S.
banks, as of December of previous
years and August of this year

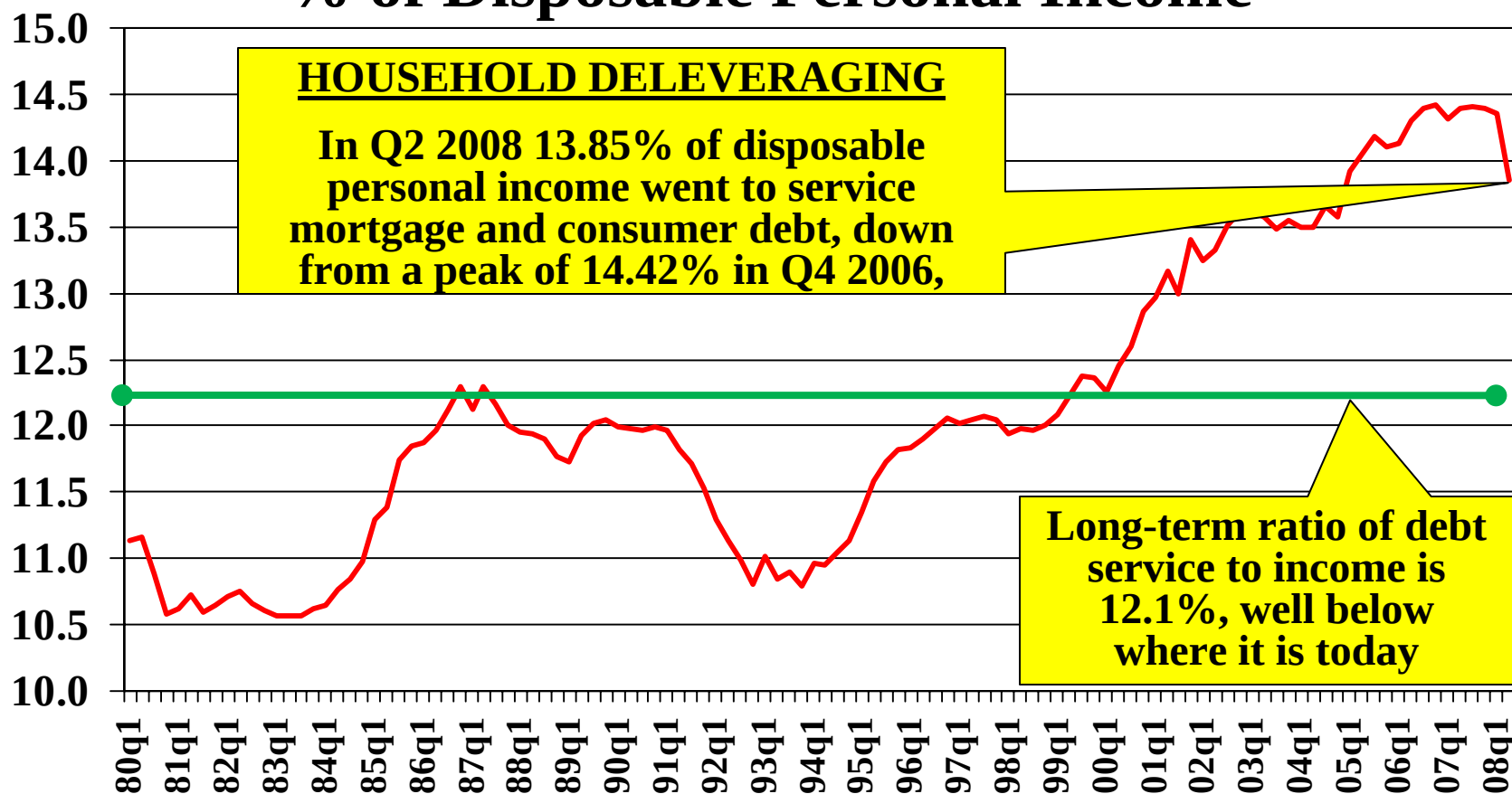
In trillions



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Ratio of Debt Service Payments to Disposable Income, 1980 – 2008:Q2

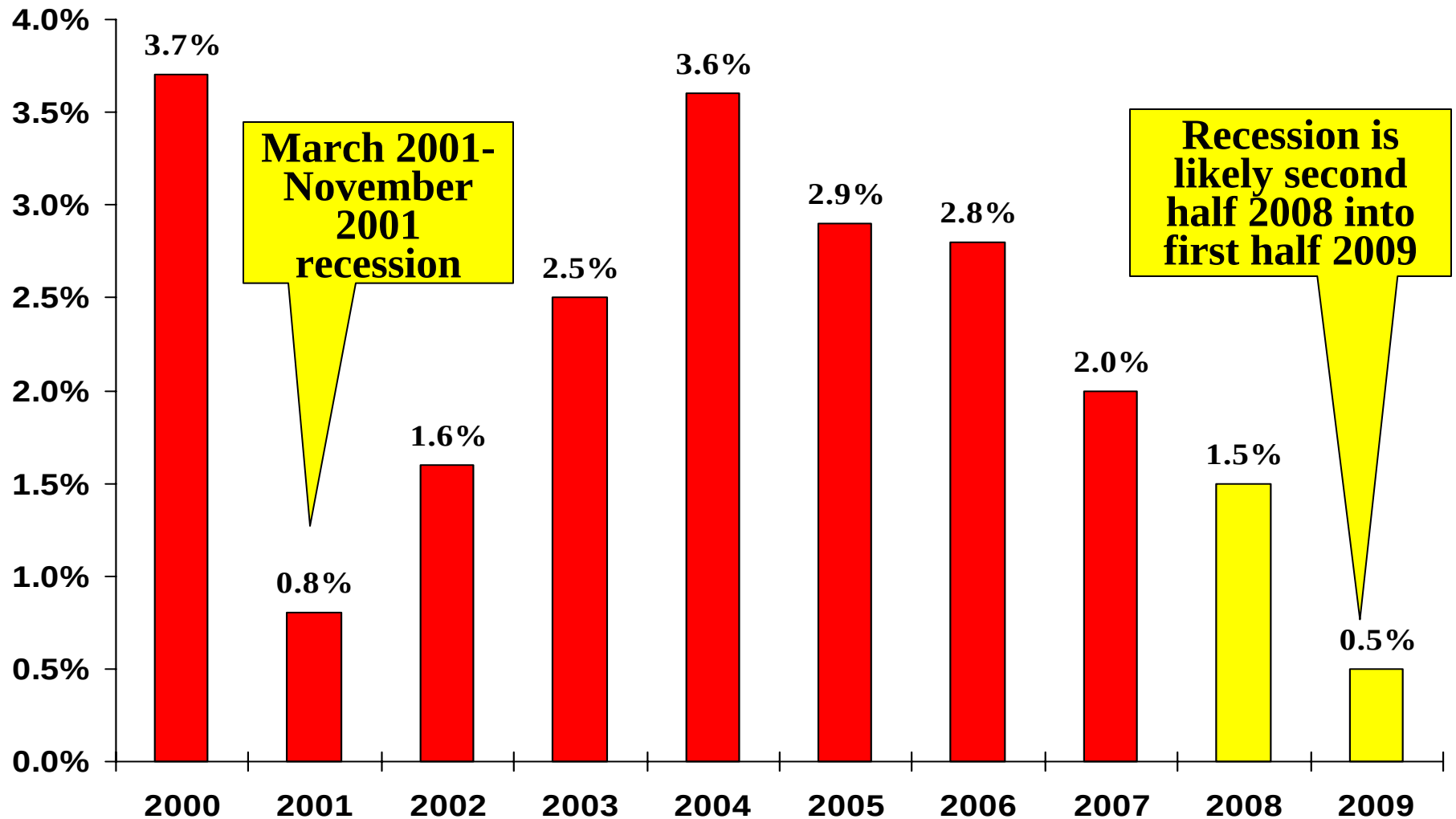
% of Disposable Personal Income



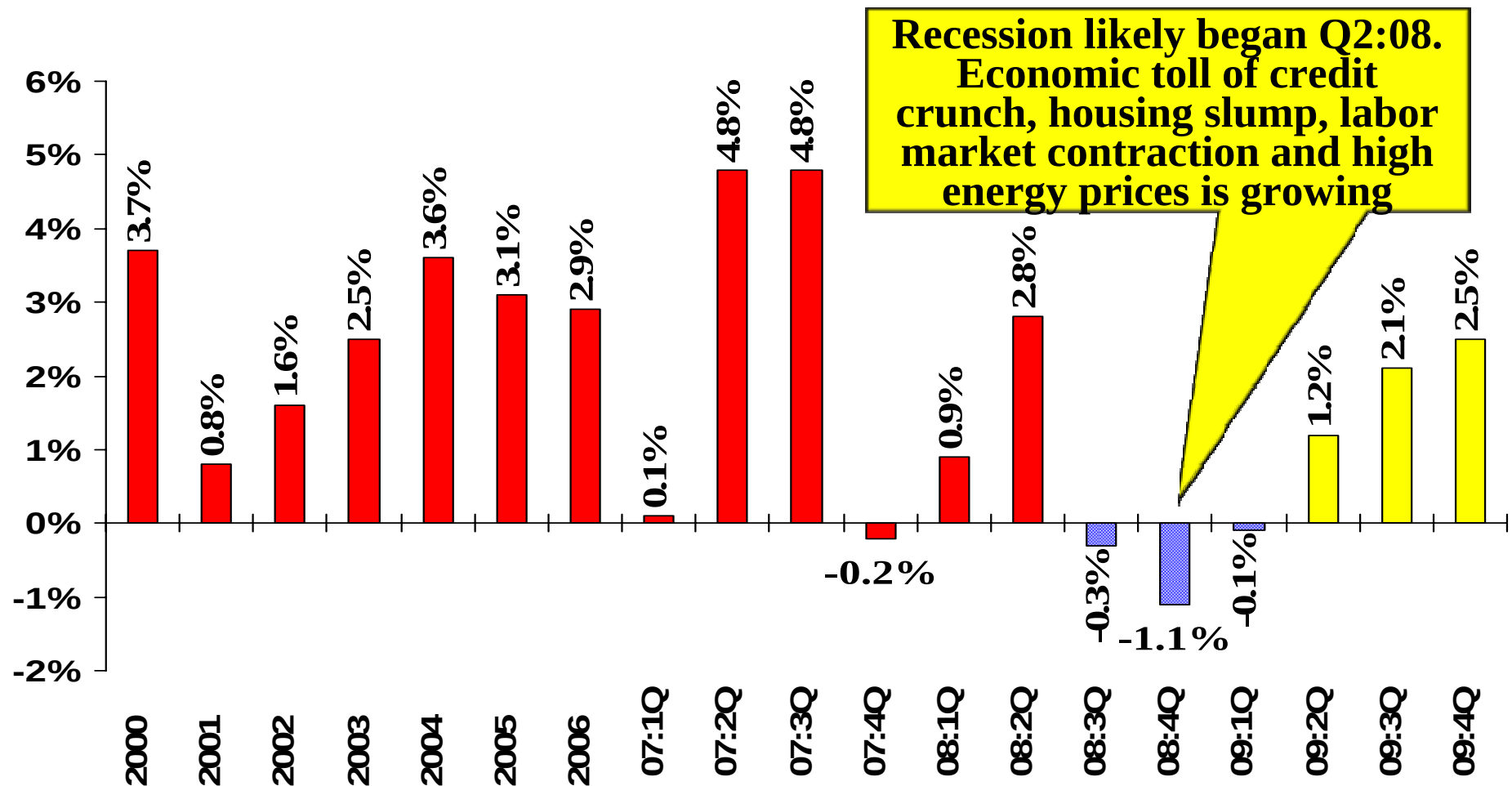
Since 2004...

- We have had a real decline in GDP growth

Real Annual GDP Growth, 2000-2009F



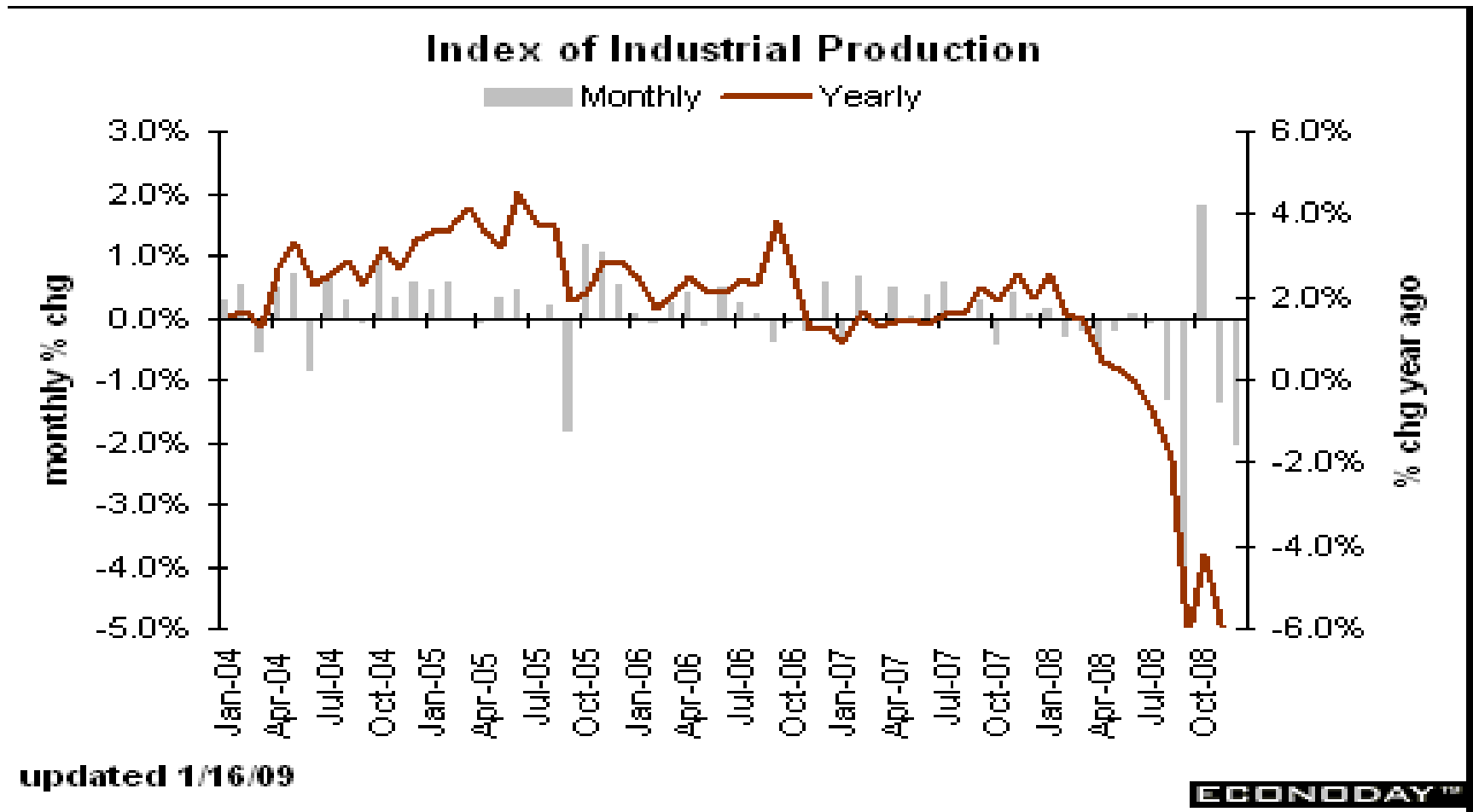
Real GDP Growth*



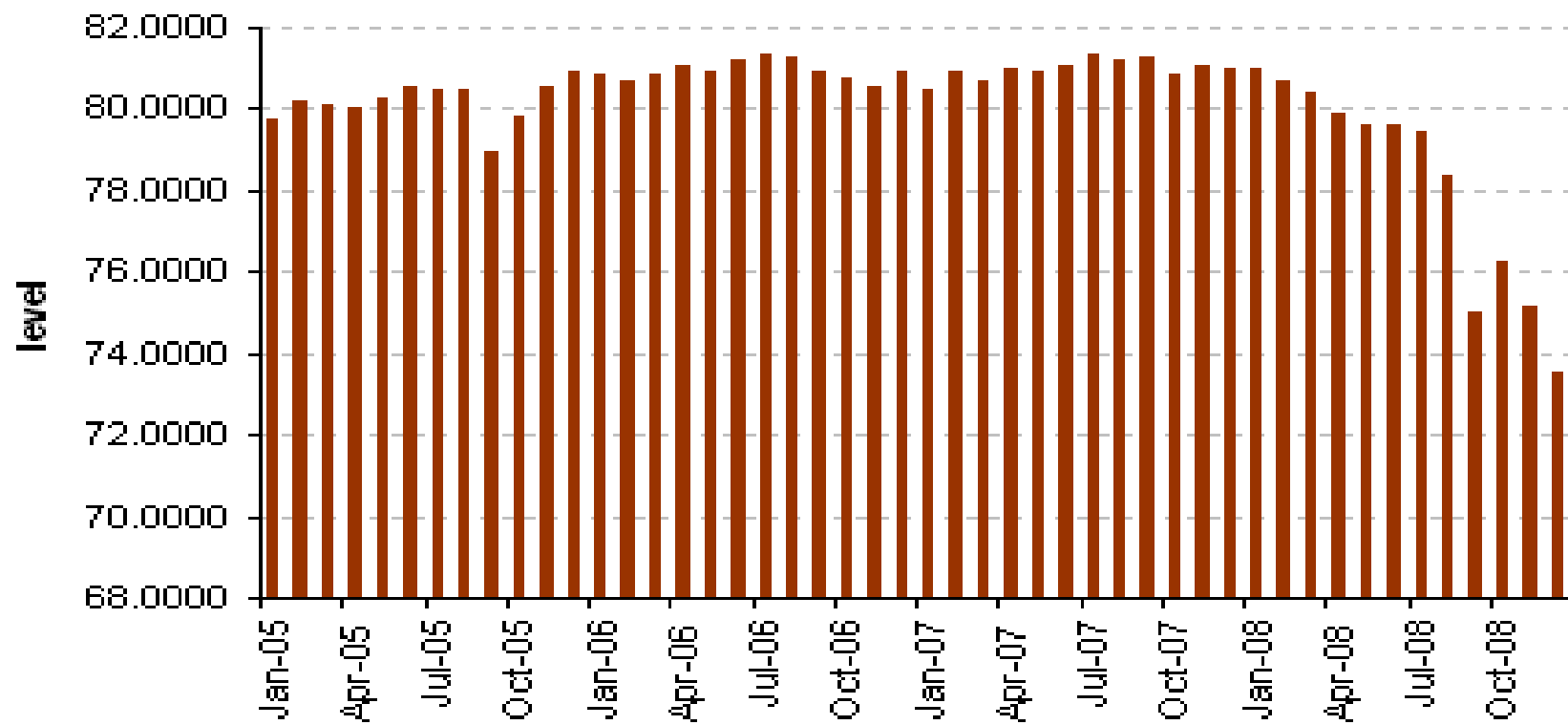
*Yellow bars are Estimates/Forecasts from Blue Chip Economic Indicators.

Source: US Department of Commerce, Blue Economic Indicators 10/08; Insurance Information Institute.

The decline of industrial production



Capacity Utilization Rate



Updated 1/16/09

ECONODAY™

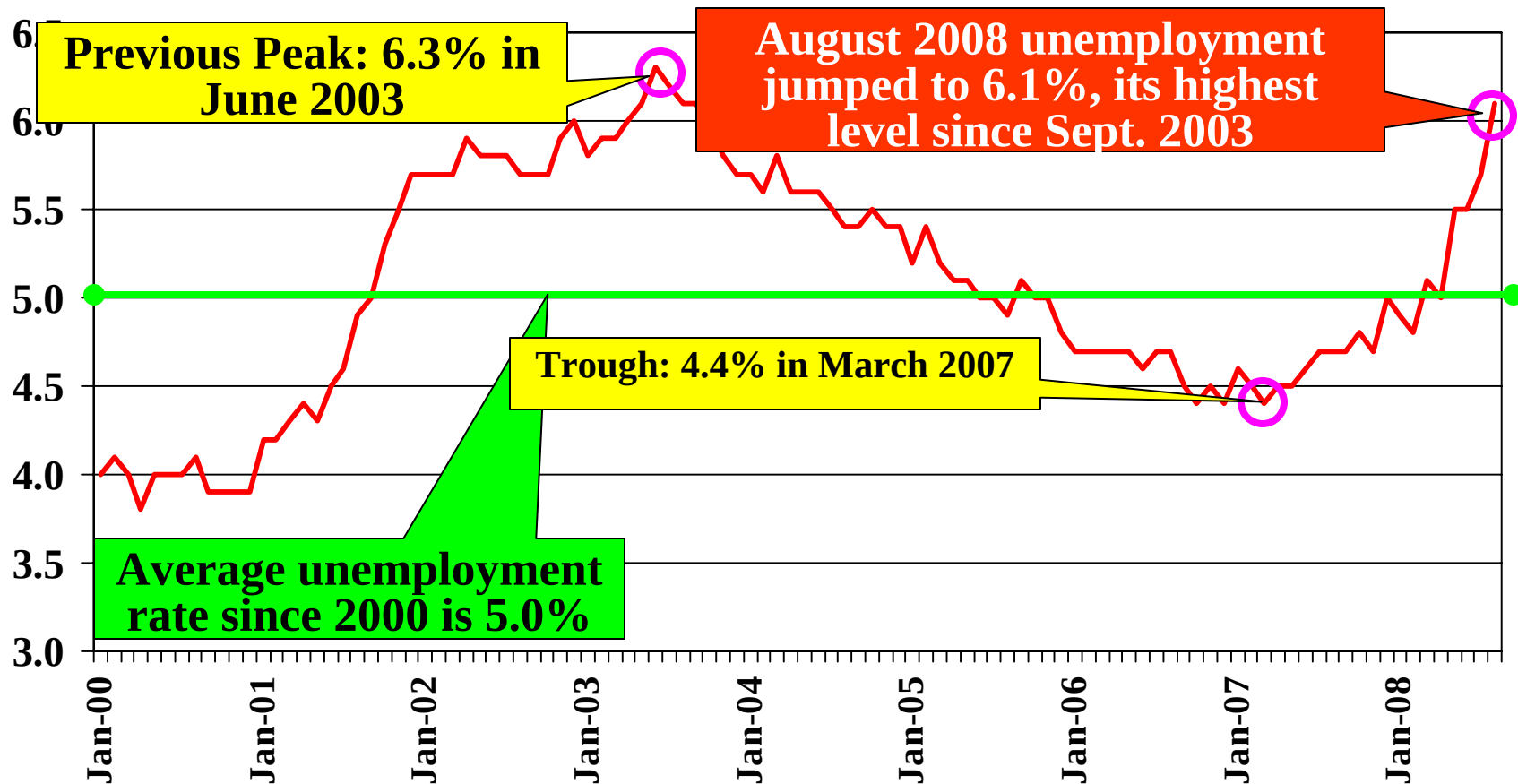
In January, 2009...

- Industrial production fell for the 6th time in 7 months
- Output at factories, mines and utilities fell by 1.8%
- Manufacturers are cutting back as consumers retrench

Unemployment...

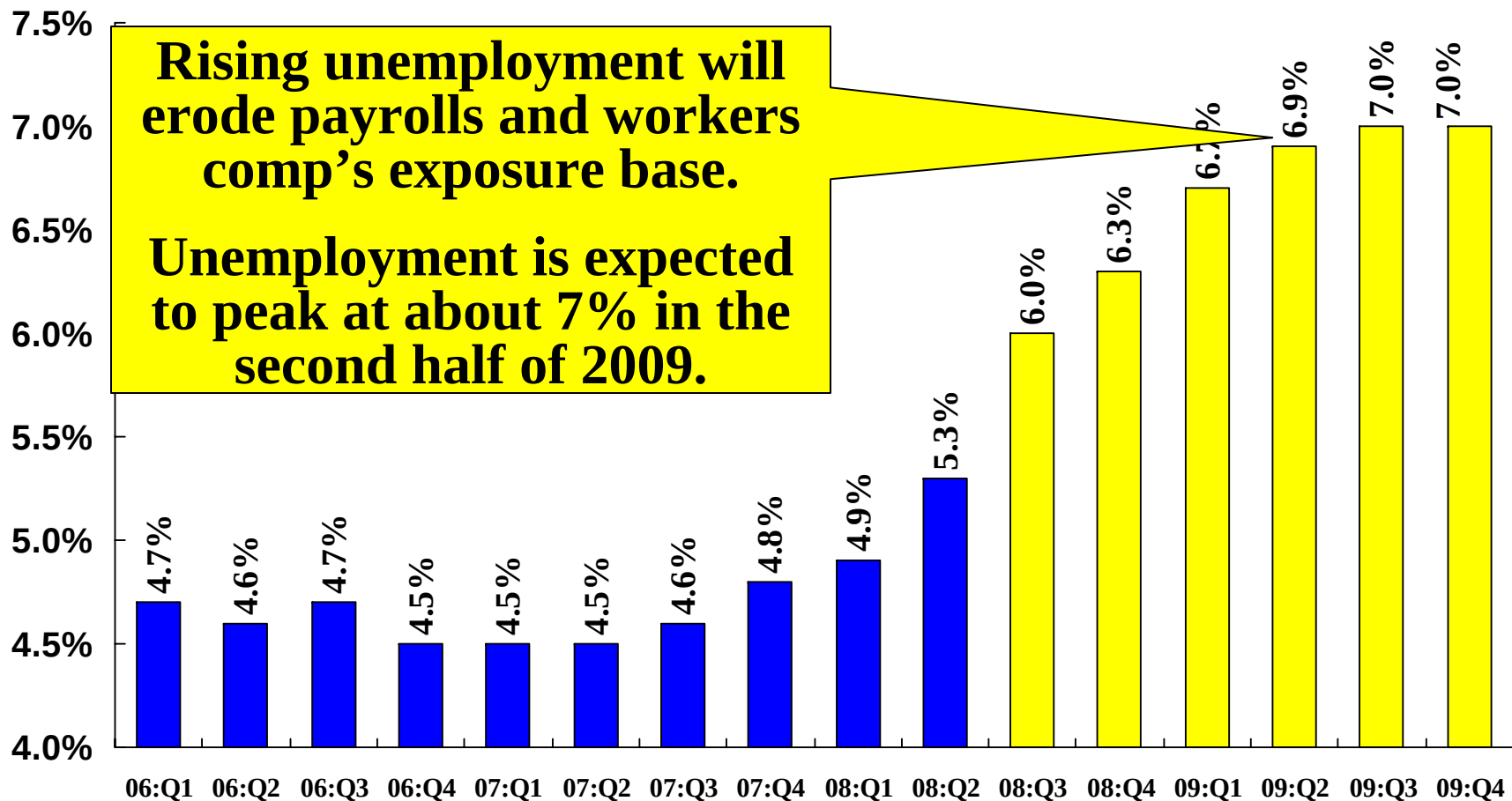
- The decline in industrial production and GDP growth has increased unemployment

Unemployment Rate: On the Rise



Source: US Bureau of Labor Statistics; Insurance Information Institute.

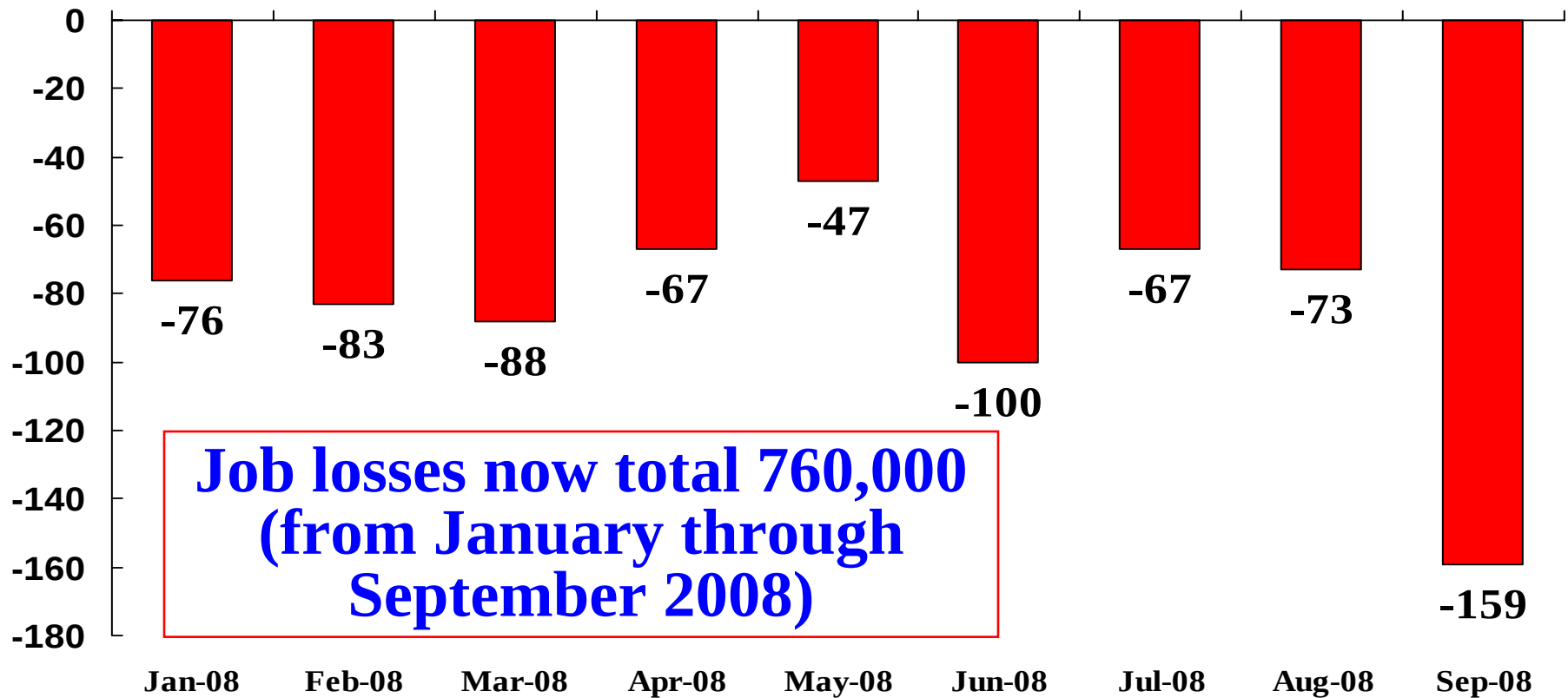
U.S. Unemployment Rate, (2007:Q1 to 2009:Q4F)*



* Blue bars are actual; Yellow bars are forecasts

Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (10/08); Insurance Info. Inst.

Monthly Change Employment* (Thousands)



The US....

- consumes about \$2 billion more in goods than we consume and people continue to take our \$ as payment
- We export about 12% of GDP but we're trading away a little bit of our country (\$)
because of our consumption

Source: [Treasury Department](#)

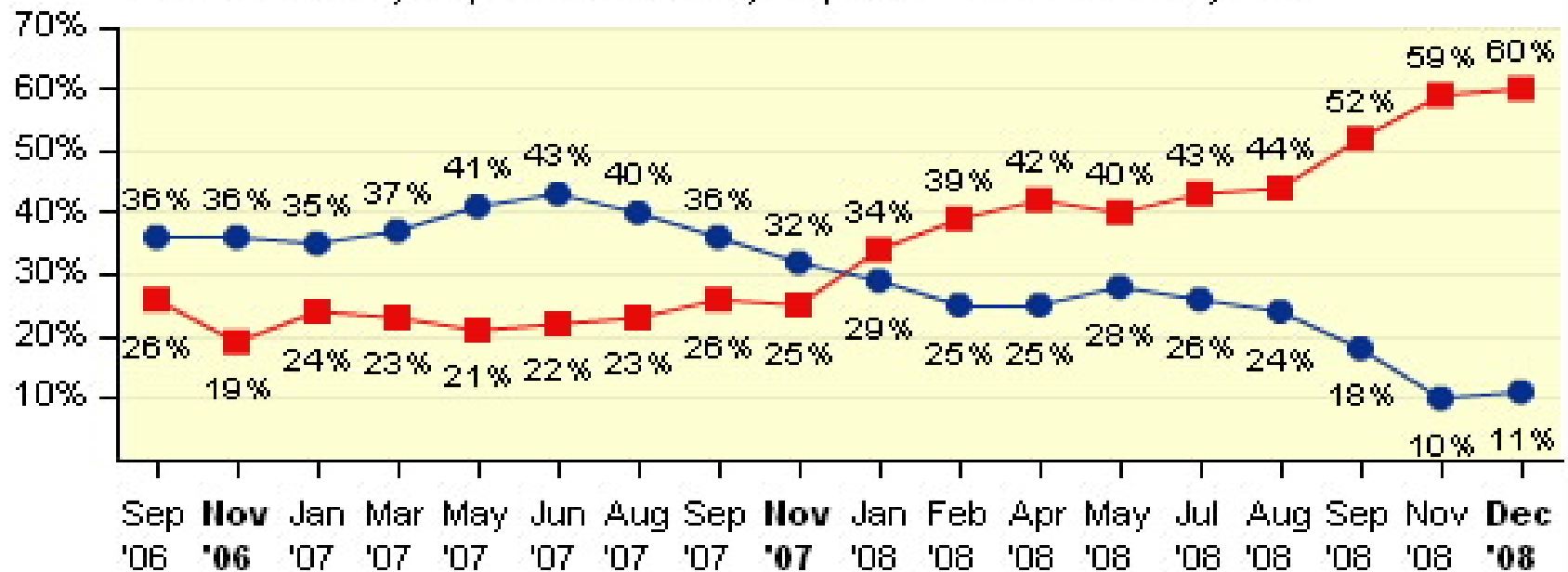
- **5 Biggest Holders of U.S. Securities by Country as of June 2008**
- Posted March 13, 2009
- **Japan** — \$1,250 billion
- **China** — \$1,205 billion
- **United Kingdom** — \$864 billion
- **Cayman Islands** — \$832 billion
- **Luxembourg** — \$657 billion

Consumer Spending

Overall Consumer Spending Results
Last 18 Surveys Comparison
Sep '06 - Dec '08

■ Spending Less
● Spending More

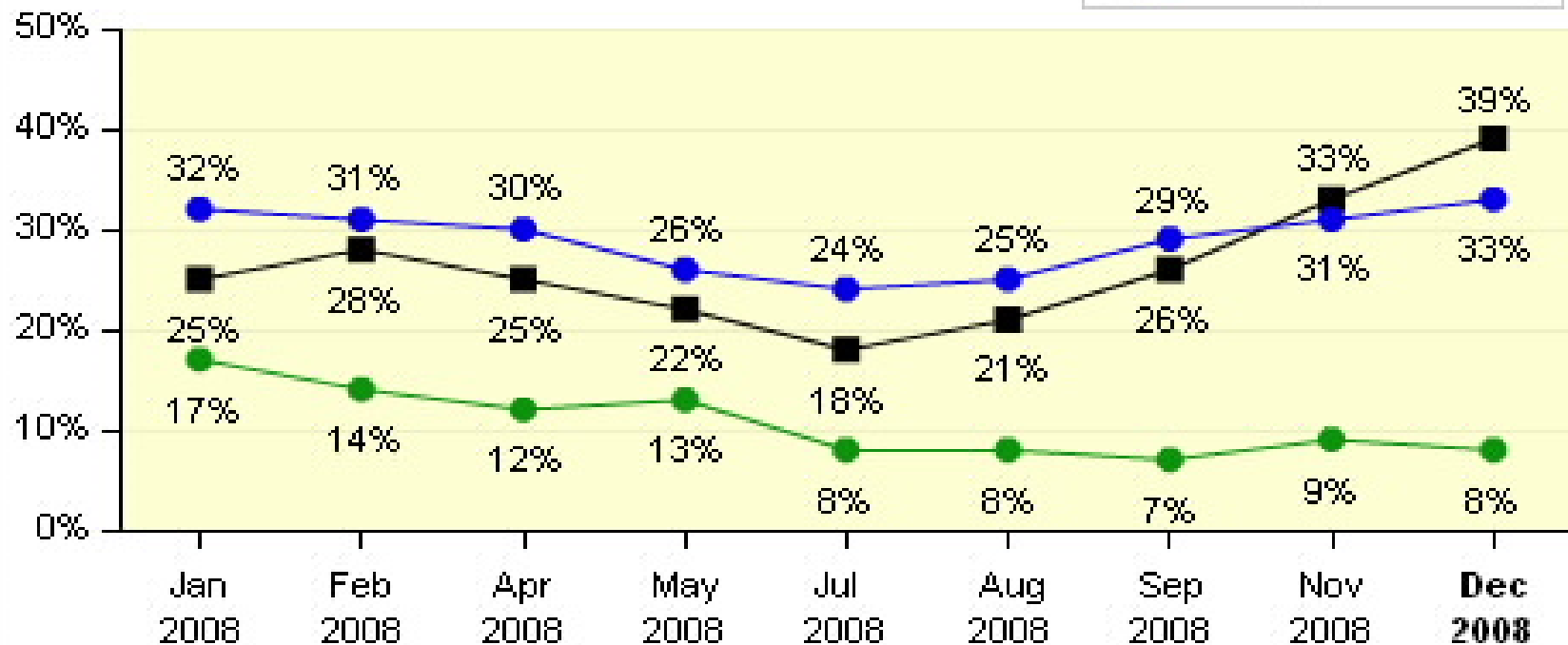
Would you say your overall spending over the next 90 days will be more than last year, less than last year, or the same as last year?



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Trying to save more...

**Consumers Who Say They're Spending Less
Because They're Improving Personal Finances**
Jan '08 - Dec '08



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Use of Credit Default Swaps and Mortgage Backed Securities...

- got out of control and the underlying credit risk in these contracts was unmonitored, many of these were tied to residential housing
- These contracts should have had more prior regulation. We lost sight of risk and leverage

First, what is Credit Default Swap?

- A credit default swap (CDS) is a contract which transfers financial risk from one party to another. In a credit default swap, the buyer pays the seller premiums over the lifetime of the contract, in exchange for the seller's assumption of risk. If the credit instrument involved in the credit default swap defaults, is radically devalued, or undergoes another catastrophic financial event, the seller pays the buyer the face value of the credit instrument.

CDS....

- Put in simple terms, let's say that John borrows some money from Suzy. Suzy might decide that she doesn't want to assume the risk of default, so she approaches Julian and negotiates a credit default swap. Suzy pays Julian premiums in exchange for his assumption of the risk of the loan. If John repays the loan successfully, the contract ends. If, however, he decides not to pay it, Julian must pay Suzy the face value of the loan.

Problems with Credit Default Swaps

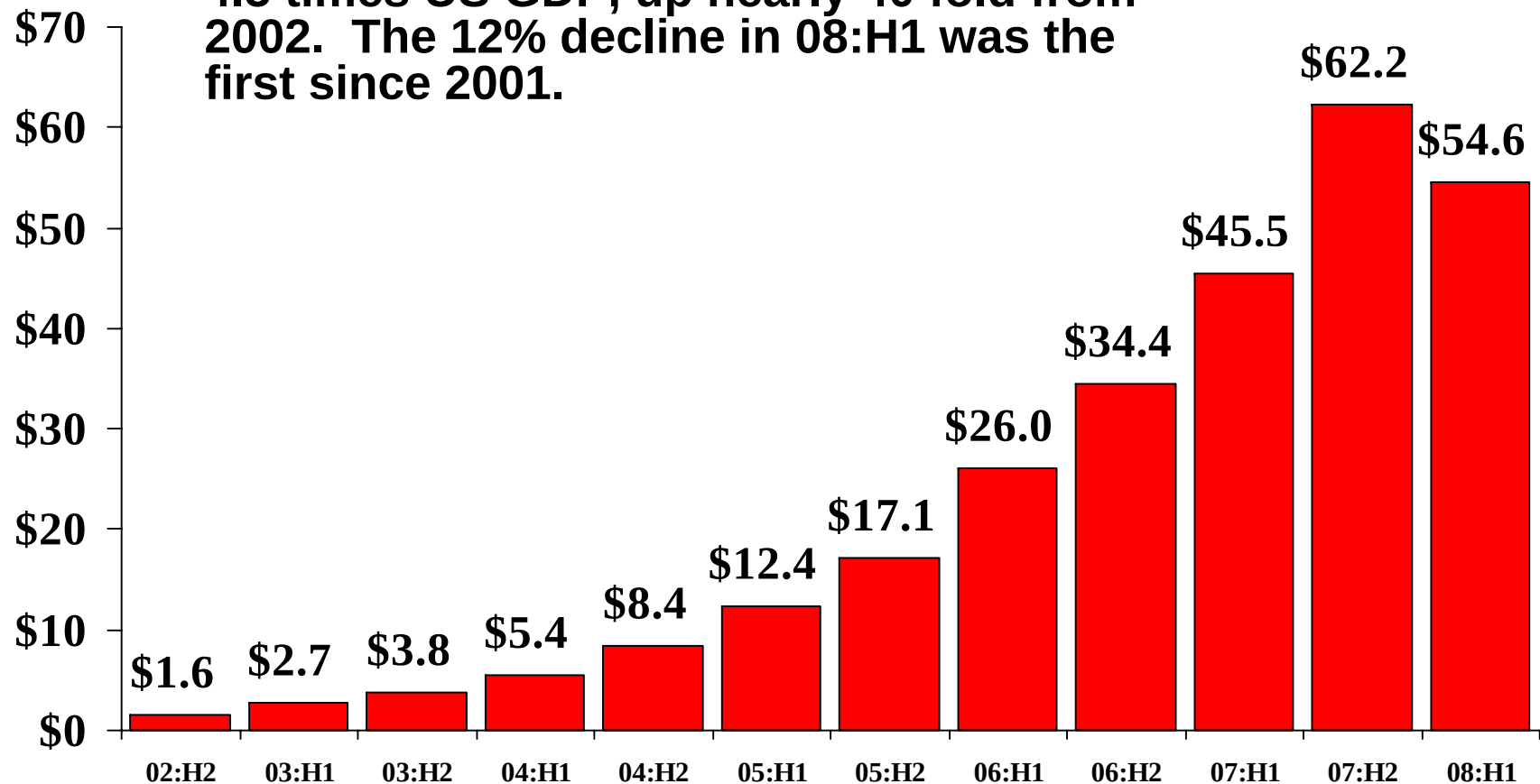
- One of the biggest problems with the credit default swap is that it is supposed to work like insurance, but it doesn't, because the insurer, the seller, is not required to provide proof of the ability to cover the debt in the event of default. Furthermore, the contract can be transferred, so while the original seller might have been able to cover the credit, people further down the line might not be able to.

CDS continued...

- The concept of the credit default swap was pioneered by JPMorgan Chase in the mid-1990s, to allow banks, [hedge funds](#), and other financial institutions to transfer the risk for corporate debt, mortgages, [municipal bonds](#), and other credit instruments. By 2007, the market in credit default swaps had grown to *twice the size* of the American [stock market](#), and because this industry was largely unregulated, some serious problems began to emerge.

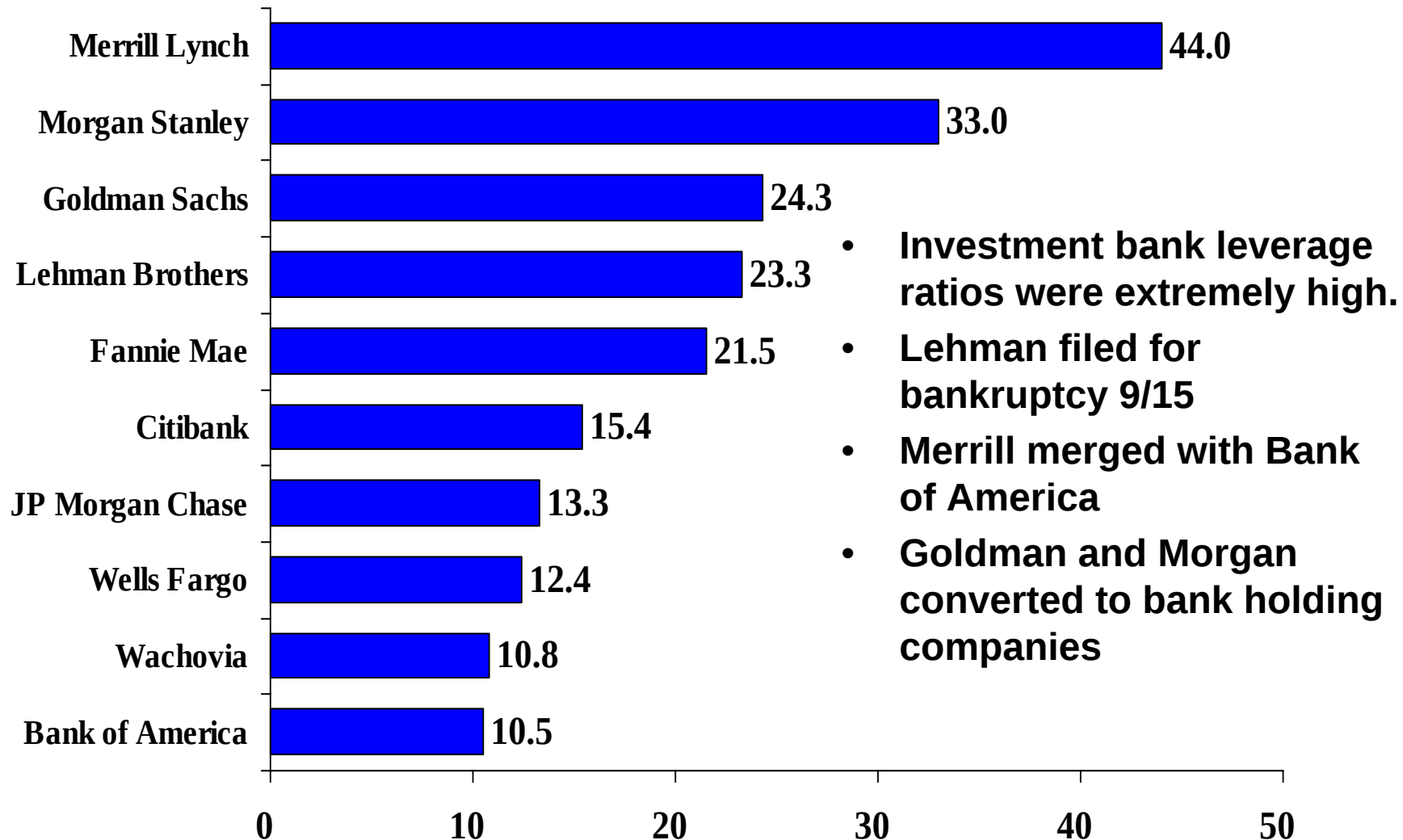
*Credit Default Swaps: Notional Value Outstanding, 2002:H2 – 2008:H1**

At year end 2007, the notional value of CDS's outstanding was \$62.2 trillion or 4.5 times US GDP, up nearly 40 fold from 2002. The 12% decline in 08:H1 was the first since 2001.



(End of calendar half (H1 = June 30, H2 = December 31)).

Leverage Ratios for Investment Banks and Traditional Banks*



How Does Leverage Work?

- **Example of Non-Leverage Transaction**
 - Buy 1 share of stock for \$100
 - Price of share rises to \$110
 - RETURN = \$10 or 10%
- **Leveraged Transaction**
 - Invest \$10 and borrow \$90
 - Stock rises to \$110
 - RETURN = \$10 or 100% (less borrowing costs)
- **This Pleasant Arithmetic Works Equally Unpleasantly in the Opposite Direction**
- **Declining asset values, seizing of credit markets made such borrowing impossible and the operating model of investment banks nonviable**
- **Investment banks and others juiced their returns by making big, bad bets with (mostly) borrowed money on mortgage securities**

Mortgage Backed Securities

- A **mortgage-backed security (MBS)** is an asset-backed security whose cash flows are backed by the principal and interest payments of a set of mortgage loans. Payments are typically made monthly over the lifetime of the underlying loans.

The history of Mortgage Backed Securities

- In 1938, a governmental agency named the National Mortgage Association of Washington was formed and soon was renamed Federal National Mortgage Association (FNMA or [Fannie Mae](#)). It was chartered by the US government as a corporation which buys [Federal Housing Administration](#) (FHA) and [Veterans Administration](#) (VA) mortgages on the secondary market, pools them, and sells them as "mortgage-backed securities" to [investors](#) on the [open market](#). FNMA was [privatized](#) in 1968 as a "[government sponsored enterprise](#)" listed on the [stock exchange](#).
- Additionally, the 1970 Emergency Home Finance Act created a new secondary mortgage market participant, the Federal Home Loan Mortgage Corporation (FHLMC or [Freddie Mac](#)) to support conventional mortgages originated by [thrift institutions](#). The Act also allowed FNMA to buy conventional mortgages in addition to FHA & VA.
- Freddie Mac [competed](#) in the [secondary market](#), where Fannie Mae had enjoyed a [monopoly](#).

So, the 6 things...

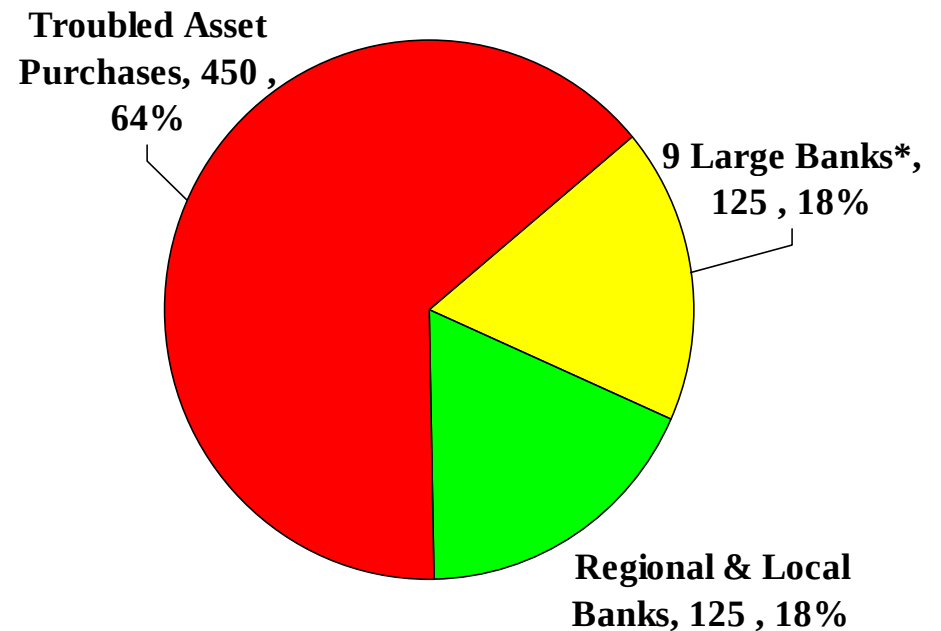
- We had a bubble that burst both in the housing market and the stock market which eroded consumer confidence
- Real wage growth started to stagnate in 1999
- Consumers leveraged up to replace lack of wage growth
- We had a decline in GDP growth that started in 2006, businesses started layoffs which has increased unemployment
- We consume \$2 billion more than we produce each day and we're trading a little piece of our country for it (\$)
- The use of credit default swaps and mortgage backed securities was unmonitored and got out of control

So, How are We Going to Survive This...

- To begin, this is what the government is going to do...
- The government considered Emergency Economic Stabilization Act, then...
- The government signed in to law the Federal Government Financial Services Rescue Package

Distribution of \$700 Billion in Funds Under Emergency Economic Stabilization Act of 2008

- Shifting Emphasis
- Original EESA allocated all \$700B to Troubled Asset Relief Program
- View was that TARP would take too long and that liquidity/credit crisis required direct infusion of capital in banks by feds



Federal Government Financial Services Rescue Package

- **THE SOLUTION: A 5-POINT PLAN**
- **Treasury Purchase of Equity Stakes in Banks**
 - Treasury will buy up to \$250B in senior preferred shares in wide variety of banks (out of \$700B in EESA)
 - 9 largest banks get \$125B
 - Stakes come in the form of non-voting shares and pay 5% for first 5 years and 9% thereafter
 - Feds get warrants to buy up to 15% more shares
 - Banks can buy back stake from government
 - Must agree to limits on CEO compensation
 - **GOAL: Bolster bank capital/liquidity**
- **Backing New Debt from Banks**
 - FDIC will guarantee new, senior unsecured debt issued by banks, thrifts and bank holding cos. Must mature within 3 years; Banks can opt in until 6/30/2009
 - **GOAL: Restore confidence of buyers of bank debt that they will be paid back (no matter what happens to bank)**

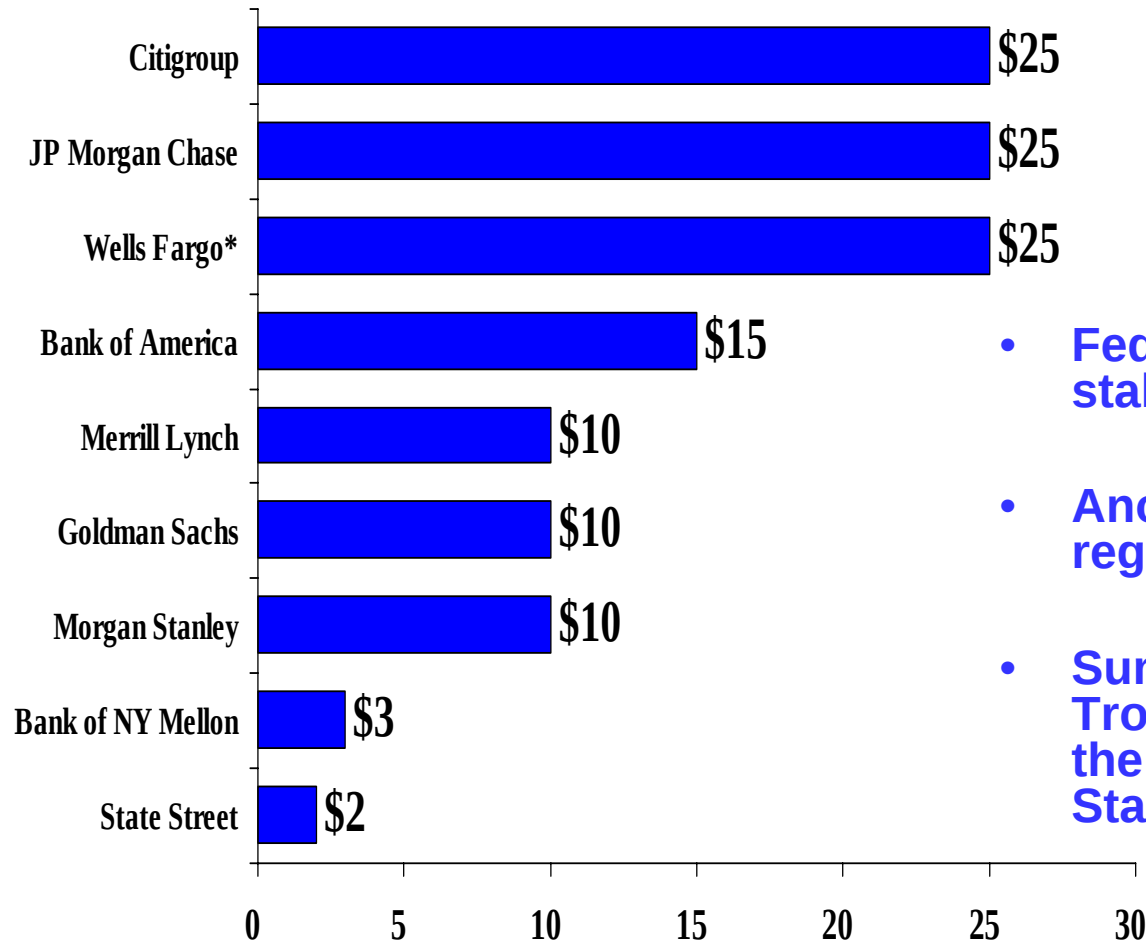
Federal Government Financial Services Rescue Package

- **More Coverage for Bank Deposits**
 - FDIC will provide unlimited coverage for all non-interest bearing accounts through 12/31/09. (Such accounts are typically used by businesses to meet short-term expenses such as payrolls)
 - Paid for by fees/premiums paid to FDIC
 - **GOAL: Boost liquidity for otherwise healthy banks (esp. regional and local banks that might see nervous depositors withdraw money in favor of bigger banks)**
- **Buy Short-Term Commercial Paper**
 - Federal Reserve will buy until 4/30/09 high-quality 3-month debt issued by businesses in commercial paper market
 - Commercial paper is the prime source of funding to cover op. expenses at many large corps. and financial institutions
 - **GOAL: Guarantees there will be a buyer of debt, so private sector buyers will be willing to buy too**

Federal Government Financial Services Rescue Package

- **Buy Troubled Assets: “Troubled Asset Relief Program” (TARP)**
 - Up to \$450B available (theoretically) available to purchase troubled assets from banks (and others?)
 - Limits on CEO Compensation in Participating Firms
 - Pricing: Debt Sold to Feds via Reverse Auction
 - Reverse auction is one in which sellers bid lowest price it will accept from the government (i.e., rather a traditional auction in which the highest bid from buyer wins). Helps ensure that the Feds (taxpayer) does not overpay for questionable debt
 - Will be sold in multi-billion dollar increments and run by outside asset managers in amounts ranging up to \$50 billion
 - Recoupment provision allows government to assess users of program to make taxpayers whole if program loses money
 - **GOAL: By removing “toxic” assets with uncertain underlying value from bank balance sheets, banks should be better able to attract capital**

Stakes Taken by Federal Government in 9 Large US Banks



- Feds announced a total \$125B stake in 9 large banks on Oct. 14.
- Another \$125B will be infused in regional and local banks
- Sum comes from \$700B in Troubled Asset Relief Program in the Emergency Economic Stabilization Act of 2008

As of January, 2009 here's a breakdown of what the top 10 TARP money recipient banks have taken:

- **Citigroup (NY): \$45 billion**
- **AIG (NY): \$40 billion**
- **JPMorgan Chase (NY): \$25 billion**
- **Bank of America/Merrill Lynch (NC): \$25 billion**
- **Wells Fargo (CA): \$25 billion**
- **General Motors (MI): \$14 billion**
- **Goldman Sachs (NY): \$10 billion**
- **Morgan Stanley (NY): \$10 billion**
- **PNC Financial Services (PA): \$7.58 billion**
- **U.S. Bancorp (MN): \$6.6 billion**

Federal Government Financial Services Rescue Package

- Other Recent Provisions
- **Fannie/Freddie Will Increase Mortgage Buying**
 - Feds step-up buying MBS in open market
- **10-Day Ban on Short-Selling 829 Financial Stocks**
 - Most major public insurers on list
 - Expired Oct. 7
- **Increase FDIC Insurance Limits on Deposits to \$250,000 from \$100,000**
- **Establish Financial Oversight Board**
 - Includes Treasury Secretary, Fed Chairman and others TBD

Federal Government Financial Services Rescue Package

Other Recent Provisions (cont'd)

Conversion of Last 2 Remaining Investment Banks (Goldman Sachs and Morgan Stanley) to Bank Holding Companies

- Recognition that Wall Street as it existed for decades is dead**
- High leverage investment bank model no longer viable in current market environment**
- New entities will be subject to stringent federal regulation in exchange for more access to federal dollars/liquidity facilities**
- Capital and liquidity requirements will be greatly enhanced**
- Reduced leverage means new entities will be less profitable**

Liquidity Enhancements

Implemented by Fed Due to Crisis

- **Lowered Interest Rates for Direct Loans to Banks**
 - Federal funds rate cut from 5.5% in mid-2007 to 1.5% now
 - Most recent cut from 2.0% to 1.5% globally coordinated on Oct. 7
- **Injected Funds Into Money Markets**
- **Increased FDIC Insurance Limits to \$250,000 from \$100,000**
- **Coordinated Exchange Transactions w/Foreign Central Banks**
- **Injected Cash Directly Into Banks; Will Take Ownership Stake**
- **Created New and Expanded Auction & Lending Programs for Banks**
 - e.g., Term Auction Facility expanded to \$900B
- **Started Direct Lending to Investment Banks for the First Time Ever**
- **Authorized Short-Term Lending to Fannie/Freddie, Backstopping a Treasury Credit Line**

Why Have Credit Markets Frozen & Why Are They So Hard to Thaw?

1. **CRISIS OF CONFIDENCE:** Banks are Fearful of Lending to Each Other as Well as Even Highly-Rated Corporate Risks
 - Lehman and bank bankruptcies have deeply damaged faith in the financial integrity of financial institutions
 - Fear has spread to European banks
 - Concern that US actions are insufficient and Europe's too uncoordinated
 - CONSEQUENCES: Lending is shriveling and LIBOR is rising
2. **DELEVERAGING:** Banks & Investors Want to Reduce Debt
 - Issuing new loans, even short term, slows purge of debt from balance sheets
3. **TANGLED WEB OF RISK:** Financial Innovations Designed to Spread and Hedge Against Risk Obscure Where Risk is Held and in What Amounts → Genesis of the Systemic Risk
 - The packaging, securitization and global sale of collateralized debt obligations (CDOs) such as mortgage backed securities (MBS) has made every financial institution in the world vulnerable
 - Explosive and widespread use of derivative hedges such as credit default swaps create large numbers of potentially vulnerable counterparties

Positive Signs & Silver Linings in the Economy

1. **CREDIT THAW**: Banks are beginning to lend to each other and to others in unsecured credit markets
 - Key interest rates falling (LIBOR)
2. **DELEVERAGING**: Banks, Businesses & Consumers reducing debt loads to more manageable levels
3. **ENERGY PRICES FALLING**: Oil prices are down more than 50% and gas prices down about 33%
 - Falling energy prices are potent economic stimulus and confidence builder
 - Helps all industries
4. **INFLATION THREAT WANING**: Falling energy, commodities prices will help consumers and cut off price spiral
 - Less erosion in real wages
5. **AFFORDABILITY IN HOUSING**: Rapidly falling home prices will attract more buyers, more quickly
 - Critical to clear away excess inventory, stem foreclosures

Post-Crunch: Fundamental Issues To Be Examined Globally

- **Failure of Risk Management, Control & Supervision at Financial Institutions Worldwide: Global Impact**
 - Colossal failure of risk management (and regulation)
 - Implications for Enterprise Risk Management (ERM)?
 - Misalignment of management financial incentives
- **Focus Will Be on Risk Controls: Implies More Stringent Capital & Liquidity Requirements**
 - Data reporting requirements also likely to be expanded
 - Non-Depository Financial Institutions in for major regulation
 - Changes likely under US and European regulatory regimes
 - Will new regulations be globally consistent?
 - Can overreactions be avoided?
- **Accounting Rules**
 - Problems arose under FAS, IAS
 - Asset Valuation, including Mark-to-Market
 - Structured Finance & Complex Derivatives
- **Ratings on Financial Instruments**
 - New approaches to reflect type of asset, nature of risk

Post-Crunch: Fundamental Regulatory Issues & Insurance

- Unclear How Feds Will Approach and Implement New Regulations on Financial Services Industry
 - **Option A:** Could take “Big Bang” Approach and pass massive, sweeping reform measure that draws little distinction between various segments of the financial services industry
 - **Option B:** Limited legislation pertaining to all segments with detailed treatment of each segment
- Removing the “O” from “OFC”?
 - Treasury in March proposed moving solvency and consumer protection authority to a federal “Office of National Insurance”
 - Moving toward more universal approach for regulation of financial services, perhaps under Fed/Treasury
 - Is European (e.g., FSA) approach in store?
 - Treasury proposed assuming solvency and consumer protection roles while also eliminating rate regulation
 - Expect battle over federal regulatory role to continue to be a divisive issue within the industry
 - States will fight to maximize influence, arguing that segments of the financial services industry under their control had the least problems

Some of the things we can do...

Clean up the Balance sheet

- More often than not, there are some significant balances that need adjustment
- AR?
- Inventory?



Benchmark your performance

- Compare your results
- Liquidity
- Leverage
- Profitability
- Activity



Create a budget

- Without one you're flying blind every month
- A budget is critical to managing profitability



Create monthly cash flow projections

- Cash flow projections are the secret to taking control of your business
- Collections
- Inventory purchases
- Equipment purchases

Your cash flow projections will tell you

- Can I buy that new equipment I need?
- Can I payout my line of credit
- Can I hire a manager so I can play more golf?
- How fast can I get out of debt?

So, the 6 things...

- We had a bubble that burst both in the housing market and the stock market which eroded consumer confidence
- Real wage growth started to stagnate in 1999
- Consumers leveraged up to replace lack of wage growth
- We had a decline in GDP growth that started in 2006, businesses started layoffs which has increased unemployment
- We consume \$2 billion more than we produce each day and we're trading a little piece of our country for it (\$)
- The use of credit default swaps and mortgage backed securities was unmonitored and got out of control

This is what our government is doing

- Federal tax cuts
- Expansion of unemployment benefits
- Domestic spending in health care, education and infrastructure
- Social welfare provisions

American Recovery and Reinvestment Act of 2009

What we can do...

- Work with our clients to encourage them to get a financial checkup
- Clean up their balance sheets
- Benchmark their performance against industry peers
- Commit to monthly cash flow projections
- Seek out the help of a banking professional if there are questions

- Thank you for your time and attention

- **Questions?**