

**Ira W. Sohn Investment Research Conference**  
**David Einhorn, Greenlight Capital, “The Curse of the Triple A”**  
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*The views expressed in this speech reflect our opinions about certain companies or industries in which Greenlight Capital has a position or may take a position in the future.*

The actor Michael J. Fox recently published an excellent book subtitled *The Adventures of an Incurable Optimist*. In it, he writes that “the only unavailable choice was whether or not to have Parkinson’s. Everything else was up to me.”

I would like to apply that thought to why I spoke up about Lehman Brothers last year, what has happened since, and what I believe is preventing the economic recovery we would all like.

Over a year ago Lehman was in serious trouble. It had taken on a tremendous number of questionable assets, using a great deal of borrowed money, with only a sliver of equity. We had taken a short position in the stock. When I first spoke out about Lehman, the shares were more than \$60, and though Lehman’s troubles were evident, its fate was not sealed.

When I saw Lehman’s predicament and how it had effectively doubled down into the economic downturn, adding still more assets, repurchasing stock, trying to “squeeze” and intimidate short-sellers, I doubted whether Lehman would do the right thing on its own. So last May 21<sup>st</sup>, at this conference, I said, “My hope is that Mr. Cox and Mr. Paulson and Mr. Bernanke will pay heed to the risks in the financial system that Lehman is creating and that they will guide Lehman toward a recapitalization and recognition of its losses.” That, of course, did not happen.

Putting aside the question of whether Lehman should have been saved, the real question is, why wasn’t more done between the Bear Stearns bailout and Lehman’s demise to protect the system from the risk that Lehman obviously posed?

We all lost when the authorities failed to insist that Lehman recognize its losses and de-lever. In the midst of a crisis, our leaders hoped Lehman would make sensible decisions and also hoped for a market recovery so that Lehman could earn its way out of trouble. The authorities did not want to be held responsible for intervening and causing losses to Lehman equity holders. Instead they waited and hoped. Hope is a nice human emotion, but does not make for good public policy.

Now we have the Obama administration, which disappointingly seems to be following the same path as the Bush administration. The basic strategy appears to be to try to bring us back to 2006 by propping up asset prices and reflating the popped credit bubble, subsidizing bank creditors and shareholders, and delaying needed bank recapitalizations, while hoping for an economic recovery.

The official attitude appears to be that what is good for the banks is good for the economy. I question this view because the best interest of the banks is to buy time so that future earnings can outrun embedded losses, while the best hope for a rapid economic recovery rests on insolvent borrowers resolving bad debts as quickly as possible. A corporation, homeowner or consumer that has more than a manageable amount of debt is not going to hire people, invest or spend. For the economy to recover, underwater entities need to restructure their debts. Banks must be able to negotiate with their borrowers, but they can only do so after they have written down the loans as aggressively as possible. What is good for the economy is, in this sense, bad for the banks.

I know a company that was capitalized in better times and needs to renegotiate its bank debt or else turn the keys over to the bank – which in turn might cause lots of people to lose their jobs. The owners have offered to improve the situation with an infusion of new money if the banks convert some of the debt into equity. There are ten banks in the syndicate, and some of them have marked the loans at 50 cents or less and the rest have them marked at 90 cents or more. Not surprisingly, the banks that have marked down the loans would support the new funding plan, but the others would prefer a program of temporary forbearance, likely due to the accounting implications of a recapitalization. The willingness for banks to negotiate depends on where they have the loans marked.

Consider the homeowner who bought a house for \$350,000 and has a \$300,000 mortgage. The house is now worth \$200,000. The bank should restructure the mortgage to \$175,000 and figure out how to share the upside with the borrower. Otherwise, the homeowner is likely to rent the house down the street, and leave the bank with a house it must sell.

Geithner & Company prefer a policy of loan modifications. Mark Hanson of the Fieldcheck Group has observed that, “In a nutshell, the modifications are meant to keep the principal balance in place so the banks don't have to take losses, stretching the foreclosure problem out over a longer period of time. The modifications have ultra-low teaser rates and loan to value ratios that were unheard of even during the worst periods of bubble lending.” It is no wonder that the re-default rates are very high.

The modifications lack the one change that is most needed – principal reductions. Recently, Congress made a stab at giving judges the power to enforce principal reductions of bankrupt homeowners. The banks, of course, opposed the legislation because it would force them to recognize the losses. Even after the legislation was watered down to the point where it probably wouldn't have helped much, the banking lobby was sufficiently strong to defeat it.

We need banks to be willing to write down the bad loans and negotiate with borrowers. In order to do that, they need to be massively better capitalized or even *overcapitalized* so they can absorb the losses. Everyone must recognize that these losses have already occurred and it is time to own up to them, which is the clearest way to a recovery path for the economy.

The Obama team has posed the issue of bank solvency as a choice between nationalizing the banks versus supporting them with lots of taxpayer money. I believe that this is a false choice – there really is a third alternative. Bill Ackman has observed that the financial institutions

have plenty of capital; they just don't have the right type of capital. Too much of the capital is debt or hybrid equity and not enough is common equity. For most of the large banks there are lots of non-depositor liabilities that can be converted into equity, as needed, to enable the banks to be properly capitalized without requiring the taxpayers to put in any more money.

The main opponents to debt for equity conversions are, of course, bank shareholders who don't want to be diluted, and bank bondholders who would prefer to be bailed out by colossal government subsidies. These shareholders and bondholders threaten Armageddon if they are asked to shoulder the losses on the risks that they have voluntarily taken. I have posed the question of bondholders sharing the pain to many people including a Nobel Prize winning economist and a former Treasury Secretary. Invariably, they respond with something overwrought like, "without the banks, we have no economy." On the other hand, among investors that I speak with, there is broad consensus that debt for equity exchanges are needed.

Three years ago everyone understood that if a bank failed, the order of loss would be common equity, preferred equity, subordinated bonds, senior bonds and finally the FDIC. Non-insured lenders to the banks knew that they weren't buying Treasuries and they demanded compensation for the additional risk. Now, the government has arbitrarily flipped the order at enormous fiscal cost, so that the taxpayer assumes all the risk above the common equity.

A better solution than government injections into troubled financial institutions is to figure out how to induce debt for equity conversions without forcing a disorderly liquidation. This is what should have been done with Lehman. There was a price where conversions, rather than bankruptcy and liquidation, would have been in everyone's interest. Legislation to create conservatorships for holding companies to enable this to be conducted promptly, but not necessarily over a weekend, is a good idea.

I believe that the banks are not materially more solvent now than they were two months ago. What has changed is that a couple of months ago investors worried that the government might seize the banks. But the authorities, again, don't want to be held responsible for intervening and causing losses to equity holders; they are instead hoping for an economic recovery which allows the banks to outrun their problems with future earnings. This regulatory forbearance explains much of the rally in bank stocks.

If [Saturday Night Live](#) could figure out that the bank stress test was a sham, it's unlikely anyone else was fooled either. The test was designed for banks to "pass" and the regulators renegotiated the grades in a way that my eleventh grade English teacher wouldn't consider. Telling everyone that the banks are sound is not as good as actually recapitalizing the banks.

Even if banks that have not recognized losses can argue that they don't "need" more capital on technical regulatory grounds, overcapitalizing the banks would be very bullish. The rally over the last few weeks shows just how eager the market is to see the end of this crisis. If we overcapitalize the banks and direct them to resolve the insolvent borrowers, I believe that the market would react even more bullishly, and more importantly, the economy would truly begin to recover.

Once a bubble pops, it can't be reflat. Attempts to do so only end up creating the next bubble. Thus, the Internet bubble gave way to the credit bubble, which gave way to a bubble in U.S. Treasuries in a rush to safety. The Federal Reserve has commenced a program of "quantitative easing," a fancy term for printing money to prop-up the government bond market as a way to help cushion the credit bubble; this is on the heels of a 25 year bull run in Treasuries.

If we learned anything from the credit bubble, it is that giving unlimited cheap funds to AAA rated entities can be a bad idea, particularly when the entities are prone to taking full advantage of their perceived safety. Could the U.S. Government, or for that matter any of the indebted industrialized sovereigns, fall victim to the curse of the AAA rating by over-indulging in the cheap financing thrust at it, to everyone's ultimate dismay?

The U.S. fiscal position is problematic. It wasn't great during the Bush years, but now we have overt stimulus, while the tax base is shrinking. As a result, this year the deficit will be about 13% of GDP. Incrementally, the government has issued trillions of sneaky guarantees. Sneaky because they don't show up in the government accounting at the moment they are made, but only later, when they are paid. Not every guarantee will create a loss, but many will and the bills will come due over the next few years, creating a real headwind against reducing the deficit. Demographics are working against us and one investment theme to watch over the coming years is how industrialized nations with large debts and larger social commitments to aging populations allocate the sacrifice.

In the long-term we need to manage our debt through taxation, inflation or default. Some take comfort that since we can print as much money as we want – the Fed can become the purchaser of government debt as a matter of first and last resort – default is out of the question. However, from a bondholders' perspective, there isn't any difference between default and being paid in wampum. And, if we don't have a credible plan that avoids ultimate payments in funny money, the authorities can lose control. Eventually, we could be forced into an uncomfortable choice of fiscal austerity versus inflationary collapse.

President Obama's handling of the Chrysler bankruptcy has added additional uncertainty into the credit markets. He has introduced a quixotic idea: that creditor recoveries in troubled situations can be determined by an arbitrary sense of shared sacrifice rather than legal agreements and long established prior practice. One government official noted in the Wall Street Journal, "You don't need banks and bondholders to make cars." Well, after the money has been lent, who needs the lender? But where do you draw the line? Should a politically driven shared sacrifice theory apply to lenders of other troubled entities? When teachers and firefighters are losing jobs and benefits, will municipal bondholders be asked to share in the collective sacrifice? Might the shared sacrifice theory eventually extend into the U.S. Treasury market during a crisis?

Already the long-end of the bond market is sensing a problem with the long-term implications of all the short-term fixes.

I'd like to spend a minute discussing AIG. I believe most of the discussion about compensation at financial institutions is a populist diversion. If the goal is to avoid excessive risk in the system, the proper response is to reduce it directly by enforcing much greater capital requirements. The lower leverage will also have the side effect of reducing the future peak returns, which will mean less egregious compensation.

Both President Obama and Chairman Bernanke have said that the problem with AIG was that greedy people put a hedge fund on top of an insurance company. As I see it, AIG failed precisely because it was not a hedge fund, but a highly regulated, AAA rated insurance company. Call it the Curse of the Triple A. The market incorrectly believed that regulators and rating agencies carefully monitored its risk profile and activities. As a result, AIG was able to abuse its access to unlimited cheap financing without its counterparties performing any additional credit analysis or demanding any collateral. Hedge funds can't abuse the system in the same way, particularly in the aftermath of Long Term Capital Management, as lenders pay much more attention to hedge fund counterparty risk and collateral requirements. Had AIG been a hedge fund as President Obama and Chairman Bernanke claim, none of this could have happened.

Come to think of it, many of the spectacular failures during this crisis bore AAA ratings. The Government Sponsored Enterprises, the monoline insurers, AIG and General Electric, whose slow moving train-wreck is ongoing, suffered the Curse of the Triple A and damaged their companies with sizable harm to the economy at large. The only AAA rated (or at least until recently AAA) financial institution I can think of that didn't abuse its status is Berkshire Hathaway.

Investors who bought AAA rated structured products thought they were buying safety, but instead bought disaster. They can forgive themselves by blaming the rating agencies. But if the credit markets improve to the point where newly issued AAA rated bonds price with tight spreads only to later widen or ultimately fail, investors will have no one but themselves to blame. Fool me once...

Investors have figured this out and many deny that they buy bonds based on ratings unless they are forced to by law. Even Moody's largest shareholder, Warren Buffett, has said that he doesn't believe in using ratings.

We are short Moody's Investor Service. If your product is a stamp of approval where your highest rating is a curse to those that receive it, and is shunned by those who are supposed to use it, you have problems.

Moody's says that it has enormous incentive to do a good job with the ratings because the ratings are the brand. Imagine yourself the head of Moody's a decade ago. If your goal was to destroy the brand, would you have done anything differently?

The truth is that nobody I know buys or uses Moody's credit ratings because they believe in the brand. They use it because it is part of a government created oligopoly and, often, because they are required to by law. As a classic oligopolist, Moody's earns exceedingly high

margins while paying only the needed lip service to product quality. The real value of Moody's lies in its ability to cow the authorities into preserving its status.

The rating agencies' lobby is pushing "reform" through modest changes to the ratings process. Why reform them when we can get rid of them? Are we waiting for them to blow up the Lunar economy as well? Some wonder what would happen without government sanctioned ratings. It is hard to imagine how things would be any worse.

Even if the ratings were free of conflict, the unfixable issue is that the rating system is inherently pro-cyclical and economically destabilizing. When times are good, rating upgrades reduce borrowing costs and contribute to credit bubbles. The more debt they rate, the more profit they earn. When times are bad, rating downgrades accelerate a negative feedback loop and can be catastrophic for entities that rely so much on their credit rating that a rating downgrade jeopardizes their existence. The monoline insurers and AIG suffered this fate. This empowers the rating agencies to decide whether a company lives or dies. The rating agencies are sensitive to this responsibility. As a result, they fail to use the downgrade as a warning signal to investors, and when they do finally act, it is often the coup de grace.

Regulators can improve the stability of the financial markets by eliminating the formal credit rating system.

Credit analysts don't believe in credit ratings; equity analysts do. Moody's shares trade at 19x estimated earnings that, *wink-wink*, they are supposed to beat. Ironically, for a firm that evaluates credit, its balance sheet is upside down, with a negative net worth of \$900 million.

That is a lot to pay for a franchise with a socially undesirable product and a shattered brand that exists at a time when the government is considering broad reform in its mission to fix some of the systemic regulatory issues that got our economy into trouble in the first place.

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AIG, GE and even the U.S. Government all have the problem of relying on the easy financing and false confidence brought upon by the myth of AAA credit ratings. JFK said, "Belief in myths allows the comfort of opinion without the discomfort of thought."

As a society we need to de-lever and President Obama and the policy makers are not stepping up to the plate, but are instead trying to stretch things out in the hope that time will solve the problems. Forbearance has not stopped people from losing their jobs or prevented asset prices from falling; it is delaying the recovery.

I believe President Obama ran for our highest office because he had a broad vision for the country on issues like healthcare, energy, and America's role in the world. As Michael J. Fox might put it, the only unavailable choice for President Obama was whether or not we have a financial crisis. Everything else is up to him.

I am optimistic because even though I believe that Secretary Geithner is leading us down the wrong path, President Obama has demonstrated an ability to change his mind in other areas. To me this reflects the work of an intelligent pragmatist acting upon fresh understanding. I am optimistic that President Obama is capable of making similar reassessments of the economic rescue plan, and change direction there as well.

I have one final area that I'd like to cover. Seven years ago, I first spoke at this conference and, as you all know, discussed our short thesis on Allied Capital. The staff of Greenlight pledged half its share of any profits on that position to the Tomorrows Children's Fund. In 2005, when the investment took longer than we imagined, we donated \$1 million, as we felt that the children who benefit from this charity should not have to wait.

When I published *Fooling Some of the People All of the Time* last year, we promised the other half of any profits to two other worthy organizations: The Project On Government Oversight (POGO) which is an independent nonprofit that investigates and exposes corruption and other misconduct to achieve a more effective, accountable, open, and ethical federal government, and the Center for Public Integrity (CPI) which produces original investigative journalism about significant public issues to make institutional power more transparent and accountable.

Now our short has finally paid off. Allied would no doubt argue that it took an enormous collapse in the credit market for that to happen. I would respond that it took a historic credit bubble to prop-up Allied all those years.

At the end of my book I tried to explain why, even though I was embroiled in a ridiculously unpleasant controversy, I felt optimistic that it would end well. With the collapse of Allied's balance sheet and stock price, the matter is now finally resolved. I am honored on behalf of every member of Greenlight, each of whom is a part of this contribution, to donate an additional \$6 million, to make a total of \$7 million, to these three organizations to help each of them carry out their important mission. The good work they do gives us all a reason to be optimists.