monitor

Reprinted from the Convention Issue 2007 Issue, Vol. 34, No. 7

FUNDING IN 2007 — Full Retinal Detachment

A Candid Viewpoint From Dale Kluga of Cobra Capital, LLC

When the *Monitor* called and asked me to comment on the recent conditions in the funding side of the business, little did I know that in about 20 minutes I would be going under the knife. I was grappling with what I would say first, and was soon confronted with phrases like "retinal tear," followed by, "and you are bleeding inside your eye," from my doctor. She then scolded me for not coming in sooner until she realized that her "pit bull" receptionist refused to book me any sooner.

DALE KLUGA
President, Cobra Capital, LLC

So, that's how my day started, pupils fully dilated, dazed and confused, which probably also describes the state of mind of many bank CEOs over the past several months. Heck, even Wachovia's balance sheet was called into question. Imagine that, Wachovia. JP Morgan Chase's Jamie Dimon personally negotiating the Home Depot workout? Last time I remember a top bank executive negotiating in the trenches was back in 1984 when our vice chairman at Continental Bank was furiously begging for Fed funds from its tiny correspondent bank network. He was unsuccessful, by the way.

Today our nation's four largest money center banks, (with billions in illiquid corporate commercial paper on their balance sheets), are borrowing at the discount window as a public gesture of confidence in the financial system. For what purpose? To convince those smaller undercapitalized banks that they can get funding even if their access to Fed funds dries up?

No one is that naïve — not even a banker. Once you go to the window, its all over no matter how the Fed spins it. Markets smell blood quicker than a great white shark. That gesture was not intended for small banks, it was for the large super-regionals and smaller regional banks whose margins are so tight that, like me, their retinas are being torn apart. Once these regionals start tearing apart at the seams, inevitably, as my eye surgeon advised me, full retinal detachment is unavoidable.

As I learned that morning, when detachment occurs, you go blind — not unlike a liquidity crisis in the banking system, which completely blindsides a banker, who then panics. Once the bankers start panicking, the only thing left for these troubled middle-market institutions is to sell, merge or cut staff — or fail.

Take for example Citi's humungous hedge fund exposure. Now there's a great concept, conceived perhaps to dodge regulation. Here we go again, another financial vehicle that the press exaggerates as the villain for the billion dollar subprime mortgage implosion. Once again, the "unbiased" and "independent" rating agencies are front and center just like the last debacle in the subprime small-ticket leasing securitization disaster that hit our industry several years ago. The difference is that our industry's problem back then wasn't even a blip on the national radar screen. Subprime mortgages on the other hand, that is a bit more than a blip.

Today's subprime mortgage disaster is much different than our industry's subprime flame out. We were guilty of funding "true" subprime product, those which deserved nothing better than a "C" or "D" credit score classification. True, we leasing people are bold but at least we are candid, we call it like we see it. Today the press has blatantly mischaracterized the definition of subprime in the context of the mortgage problems. The scary thing is that the vast majority of these "subprime" mortgages were granted to consumers with relatively good credit scores in the upper 600s all the way up to 800s, whereas much of our small-ticket leasing subprime scores were in the sub-600 range.

Therein lies the rub. These slick hedge funds figured out how to package hundreds of billions in mortgages that did not fall into the dregs of traditional subprime credit scores. Today's defaults in many cases are from leveraged, albeit, employed debtors who historically paid their bills on time. The problem is that the rating agencies allowed themselves to be duped into taking their fees while simultaneously looking the other way.

Were the investment bankers slicker than the rating agencies? I think not. Was it intentional malfeasance? Probably, but who the heck knows and anyway, is that even relevant now? We are in a very significant pickle of a situation. No rate cut, no matter how often or how large, could overcome the dual challenges of a national and potentially, an international liquidity crisis. The consumer simply cannot spend itself out of this current national problem because we are starting to lose jobs, and this is happening even before Detroit ceases to exist. Neither can the government print more money, no matter how fast those machines can run.

The only solution I found to heal my serious wound was to seek immediate, but very scary and dramatic treatment. Another thing I learned today, when someone approaches you with an unusually long and very sharp needle and tells you that this may hurt a little, don't believe them — it's gonna hurt a ton. **m**