Risk!

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AFP—Your Daily Resource

October 2008

In the October Risk

The market turmoil takes center stage this month as L. Burke Files, financial consultant, discusses the current market risks and his view of what outcome could be in store. Financial consultant Mark Conner inspects the state of the settlements on auction rate securities and FX Risk commentator Wolfgang Koester finishes his series about new steps for multinationals in FX management.

The Power of Paybacks

Auction Rate Securities take another turn

Mark O. Conner

(excepted from AFP Exchange Oct. 2008)

As many corporate treasurers know all too well, February of 2008 was the month in which the market for auction rate securities (ARS) collapsed. It has been nine months since investors discovered that they could not get to their cash that had been invested in this heretofore reliable market for short term investing. In the time since August of 2007, corporate cash investors have endured the stress of learning about fail rate formulae, commercial paper indices, speculative markets, other-than-temporary impairments and unobservable inputs, but they have learned almost nothing about the possibilities of getting their money back. And it is beginning to look less than hopeful that this will change anytime soon, despite proclamations to the contrary…

"Landmark" agreement

From the New York Attorney General Andrew Cuomo's Web site, concerning Auction Rate Securities:

> *"NEW YORK, NY (August 7, 2008) – Attorney General Andrew M. Cuomo today announced a landmark, multi-billion dollar agreement … to recover billions in auction rate securities for investors nationwide"*

Mr. Cuomo's proclamation is perhaps a bit premature.

The precedent AFP Exchange article to this one that appeared in April 2008 was subtitled "Don't Tell Us About the Storm, Just Bring in the Ships." In announcing his office's "landmark" agreement, Mr. Cuomo seems not to have grasped that his landmark marks only about a quarter of the voyage that all ARS investors must traverse to reach resolution and get their money back. His agreements have left the majority of ships still lost at sea and other announced settlements don't offer much near-term hope for corporate holders of ARS.

The template for all such offers by broker/dealers was struck among Citigroup (Smith Barney), the New York State Attorney General's Office, the SEC and the Texas State Securities Board. For corporate ARS investors, this was an unfortunate precedent, as it fell far short of the panacea for the ARS calamity that New York AG Cuomo proclaimed it to be. In patting himself on the back in front of his constituent voters ("Main Street investors" as he called them), Mr. Cuomo glossed over the fact that his settlement failed to address about three-

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Commentary

Moral Hazard and Iatrogenic Risk

Wall Street risk as it stands today

L. Burke Files, President
Financial Examinations & Evaluations, Inc.

Systemic Risk and a Feedback Loop

Intervening in the markets does not correct any of the conditions that put us where we are today. First, the mark to market rules of accounting require that an asset with no market (not no value) must be written down to zero. If the market that buys and sells mortgage debt is gone, according to current rules my portfolio is worthless. The claim that the market for mortgage debt is gone is fiction – the owners of this debt simply have not discounted it to the point where they will find a market. The current government plan to intervene in this market tacitly acknowledges that they will pay over market price (hence, the need for government intervention). The intervention will artificially support the price of these obligations and the market will lose its feedback mechanism, likely prolonging the problem.

The institutional losers in this "crisis" all have one thing in common—the same assets were held by everyone. The banker wrote a mortgage, which was bundled into a Collateralized Debt Obligation (CDO) by an investment banker who had it guaranteed by an insurance company. The insured mortgage was then put into a fund, and the fund's shares were sold to the banker and the insurance company. It's clear to see that everyone at the table held essentially the same asset—and all took the same position. This type of arrangement will amplify even the smallest perturbation.

How to hedge this problem is to distance

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quarters of the ARS problem. From the New York AG's Web site:

"Under Cuomo's settlement, Citigroup has agreed to buy back, no later than November 5, 2008, all illiquid auction rate securities from all Citigroup retail customers, charities and small to mid-sized businesses. These customers, who number approximately 40,000 nationwide, have been unable to sell their securities since February 12, 2008. Their securities are worth more than $7 billion."

This deal leaves out nearly all of Citigroup's corporate cash clients, a group that holds about $20 billion in ARS. Add to that the volume of ARS that Citigroup sold to other broker/dealers and thus on through to additional corporate investors and the total for ARS that originated with Citigroup would approximate about $25 billion. About all corporate investors can hope for from Cuomo's "landmark" agreement is this:

"Citigroup will also … undertake to expeditiously provide liquidity solutions to all other institutional investors …"

Apart from not offering much in the way of clear help, this language further impinges on corporate cash investors' chances for recovery. By lumping corporations in with "institutional investors", the agreement seems to imply that corporations are different from the presumed, less sophisticated individual investors who were inclined to believe brokers when they were told that ARS were as good as cash. This is a flawed characterization and also seems to indicate that Cuomo and other negotiators were inclined to swallow this rationalization from the broker/dealers, potentially saving them many billions more than they are promising to pay retail clients for their ARS. The plain reality is that corporate treasury professionals were in precisely the same situation as individual investors - misled.

Who is the true investor?

Corporate treasury folks responsible for investing their companies' cash assets are not institutional investors. Apart from having large scale assets to invest, a corporation does not fit the definition of an institutional investor. A corporate investor typically lacks all of the following traits of a true institutional investor:

1. Professional training as a full-time investor
2. Professional portfolio management tools and resources, such as:
   a. Portfolio management software platform
   b. Fixed income research staff and capability
   c. Information sources like Bloomberg, Telerate, and other bond market data sources
   d. A bond calculator and other analytical tools
3. Experience working as a market professional, i.e., bond trader, portfolio manager, fixed income research analyst, or institutional broker
4. A job description that comprises only investment duties

Investors with these advantages would have been in a better position to have gathered intelligence about the state of the ARS market and, indeed, many real institutional investors did just that. But corporations were as in the dark about the ARS market as any individual investor and, sadly, as much as many brokers were, as well. But so far, the Cuomo-led deals don't comprehend or bother to acknowledge this fact and thus corporate investors have been unfairly moved to the back of the line for settlement monies.

The ARS agreements have also touched off a sub-contest among ARS underwriters (Citigroup, Goldman Sachs, UBS, et al) and the dealers who operated as resellers of the ARS investment product (Credit Suisse, Legg Mason, Fidelity, etc.) Major investment banking firms who brought ARS issues to market on behalf of public finance and other investment banking clients were eager to enlist the distribution aid of outside dealers who themselves had many corporate cash clients, especially when selling pressure was increasing daily. While Fidelity's relationship with Goldman Sachs has garnered most of the attention paid to this arrangement, many other firms resold dramatically more ARS to their corporate clients than Fidelity did to its individual clients. Reseller firms claim that the underwriter firms should be on the hook

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Published by the Association for Financial Professionals, Inc.

Subscriptions
www.AFPonline.org/risknewsletter

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to buy back the ARS as they were not in as information-privileged a position to understand the ominous state of the ARS market as the underwriters were. This is a plainly spurious claim.

Reseller firms had daily, direct communication with the ARS trading desks of the larger underwriter firms. Their own trading personnel had a sufficient, general understanding of how the market worked to have asked the right questions to get the right reconnaissance that could have been shared with their own ARS clients. Even without this understanding, it should have been shockingly clear to them each time they reviewed the inventory runs that the underwriter firms shared with them no less frequently than every day that ARS inventories were snowballing beyond reasonableness and when they saw ARS rates rise to inordinately high levels relative to other money market investments. Their claims of an impoverished ability to read the markets is nothing less than a stalling tactic meant to slow the efforts of regulators to hold them accountable for their sloppy sales practices.

But what does all this mean for corporations holding illiquid ARS?

It means that the processes by which any sort of resolution might occur will now stretch out over many more months and, more likely, years.

As is so often the case, regulators' efforts necessarily involve an initial phase of educating themselves and conducting their discovery work. There will also have to be a mediation of the argument between underwriters and resellers, causing more delay and further burdening the FINRA arbitration capacity. Issuers may yet press their claims against underwriters for having forced them into a situation where they had no choice but to refinance their ARS on very dear terms. Issuers will continue to face very strong market headwinds in attempting to refinance ARS. Brokerage firms will be seriously distracted by having to prepare for and appear at arbitration hearings. There will have to be a clearing process for satisfying the tens of thousands of customer claims for ARS repurchases, a process that does not yet even exist. The brokerage firms themselves have set out time tables for repurchases that will commence not in future months but in future years. And, lastly but most ominously, broker/dealers will have to come up with the money, not an easy exercise when the markets are so unfriendly to yet more rounds of fundraising by financial companies.

Adding to all these obstacles is the basic intransigence broker/dealer firms are showing to their ARS clients. A very large number of corporate cash clients are being turned away at the gate when approaching their brokerage firms to inquire about real and permanent liquidity solutions. Apart from offering loans collateralized by the failed ARS, brokers are offering nothing in the way of outright make-whole solutions. Countless companies who have submitted written complaints to firms have been told "Sorry, we don't agree with your position that we did anything wrong" and are shown the door and the brokerage firms themselves appear to be under new management – their own in-house lawyers. These are the organizations that started the whole mess by selling ARS to their clients.

And there is one other large problem brewing. For publicly traded U.S. companies, there is an important risk to their earnings health that intensifies as resolution efforts for ARS drag on and as corporate ARS holders are asked to wait their turn.

Under Financial Accounting Statement (FAS) Number 115-1, any investment holding whose fair value is approximately five percent or more below adjusted cost and in this loss condition continuously for a period of at least twelve months will be deemed to be impaired for an other-than-temporary period. A temporarily impaired investment requires having its unrealized loss treated as a reduction of shareholder equity, but an other-than-temporary impairment must be deducted from earnings. As of this writing, a handful of companies have already crossed the 115-1 threshold of 12 months with a continuous unrealized loss of 5% or more but should the ARS situation remain unresolved by the end of March, 2009, hundreds of companies will be taking significant reductions in earnings in that quarter. Current settlement offers will not be of help to corporations in time to forestall this inevitability. ▲

Commentary

Moral Hazard and Iatrogenic Risk *continued from page 1*

your money from those firms selling the distressed assets and begin working with firms that have cash to invest in these discounted obligations. We, as treasury professionals, need to monitor all institutions with which we have a relationship (even using online alert services and getting monthly reports from the banking and securities regulators). Many more banks are going to fail. If you have over $100,000 in an account require the bank to bond the excess balance. Look for those who had the wisdom to avoid the bubble and have cash, they obviously have the wisdom needed to handle your money.

Even if there is a bail out, (I am writing this on Sept 25th) the form of the bailout will determine the nature of the markets. None-the-less expect the markets to be choppy for sometime and prepare for higher inflation.

Derivatives attract blame because they caught many financial professionals by surprise. Risk was managed to the point where profits could be made in 100ths of a percent—but managers did not fully comprehend the uncertainty. They all had the same position, thus any miscalculation of the market would bring them all down. Derivatives are tools, they are neither good nor bad, but must be understood by those who use them.

As globalization accelerates the flow of goods, people and currencies across sovereign borders, it also erodes state sovereignty and any financial centers hold on a market if there are friendlier hosts.

Ultimately, the U.S. may lose its place as the world leader in financial markets. The end of financial centers has been well documented. Throughout history the demise of a financial center occurs in the face of contracting markets and restrictive rules that make other financial centers more attractive.

Wall Street's biggest risk—it is the risk of being replaced. ▲

The opinions expressed in this commentary do not reflect those of the Association for Financial Professionals, its members or its staff.

A Solution – my opinion

L. Burke Files

So, how do we solve the problem without disturbing the market? We obviously have a liquidity problem, and we're going to need to put some cash in the market. The treasury needs to turn to non-traditional models when allocating cash. It makes no sense that we, as taxpayers, just buy the tailings without the minerals. A more authentic intervention would be for the Fed to take an equity position in troubled institutions – provide liquidity, taking the ore before it is separated into minerals and tailing, similar to what was done with AIG. Our 537 public servants need to pass the reforms proffered many years ago and to stop: i) incentivising GSE to take inappropriate measures, ii) making a financial institutions a tool of social engineering, and iii) over regulating.

AFP EconWatch—A brief overview of economic events **October 13, 2008**

Measure	Numerical Trend	Commentary
FOMC Meeting October 8, 2008 www.federalreserve.gov/newsevents/press/monetary/20071031a.htm *Source: Federal Reserve*	**Fed Funds Target Rate** Oct 8 08: 1.50% Sep 15 08: 2.00% Sep 18 07: 4.75%	Acting in conjunction with a number of central banks, including those of the EU, UK, Canada, Switzerland and Sweden, the Federal Open Market Committee lowered the fed funds target rate from 2.00% to 1.50%. The statement notes that the FOMC took the action "in light of evidence pointing to a weakening of economic activity…" The Fed also lowered the discount rate from 2.25% to 1.75%. Both moves were approved unanimously by the committee members.
International Trade August 2008 www.census.gov/foreigntrade/www/press.html *Source: Census Bureau*	**Trade Balance Billions** Aug 08: $59.1 Jul 08: $61.3 Aug 07: $55.3	Exports in August totaled $164.7 billion while imports were $223.9 billion, bringing the total goods and services deficit to $59.1 billion. Both exports and imports declined ($3.4 billion and $5.5 billion, respectively). While the trade deficit for goods declined (5.3%), the surplus in services also fell during the month (7.8%). The goods deficit with China grew to $25.3 billion with those with OPEC ($19.2 billion), Canada ($7.4 billion) and the European Union ($6.8 billion) all declined.

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Fire, Ready, Aim Part Two

Benchmarking FX results & planning for long-term success

Wolfgang Koester, CEO, FiREapps

Last month, I addressed the critical first steps that multinational companies new to foreign exchange exposure management must take to gain an understanding of the impacts of foreign currency volatility on their business. Those steps included identifying where exposure might be present in your business, calculating an accurate foreign exchange exposure and validating the results in the context of the reality of your business to ensure that the results make sense. Getting these basic steps right lays the foundation for whatever strategy your organization chooses to pursue to insulate corporate value from foreign exchange risk. Of course, the question remains, "How do you know when you've gotten things right?"

While the criteria for success of any FX program may vary from one organization to another, depending upon risk tolerance and a number of other factors, all FX exposure management programs have the exact same goal: eliminate surprises. The best way for any organization to gauge the success of their FX program is to look at their actual FX gains/losses on a regular basis and compare the actual results to the benchmark of what they expected them to be based upon the underlying exposure to foreign currency, and the movement of exchange rates during the reporting period.

Step 4: Setting expectations and measuring results

At the end of each reporting period, treasurers have the opportunity to compare the results born out by their analysis and the decisions they've made to manage FX, with the actual FX gains or losses on the income statement. Benchmarking begins by simply comparing the expected results to the actual results. If your expectations match the reality, you've more than likely done a good job calculating, understanding and managing your exposure. If the results don't add up or are outside your tolerance level, you need to do some additional homework.

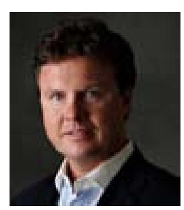
The first step is to isolate variables that could impact the results. Examples include currency rate conventions used by ERP systems to record transactions; revaluation settings and processes; invalid transaction currency balances due to posting errors; realized fx gain or loss postings tied to the clearing of transactions incorrectly recorded in local currency instead of transaction currency; under or over hedging actual exposure; journal entries posted to the wrong account and the list goes on. This is most easily performed on an entity by entity basis.

Step 5: Developing and implementing a plan for ongoing success

If you've come this far, you now have a solid foundation built on reliable FX data, an accurate FX exposure calculation, an understanding of the root causes of exposure within your business, and an alignment of your FX exposure management and business objectives. This gives you everything you need to build a risk/value-based management plan that is manageable, reproducible and process-driven.

Achieving this level of FX best practices begins by examining the weaknesses in existing processes. What have been the primary sources of errors? To what extent are process inefficiencies contributing to unpredictable results? And, considering the desire of most companies to continue to expand globally, how scalable are the processes you have in place? How well can you adjust to changing business conditions, including growth through merger or acquisition?

In a time when U.S. companies are buffeted by so many sources of risk and uncertainty, foreign exchange risk is one threat that can be overcome. Companies that take a methodical, enterprise approach to better understanding their FX exposure and implement sound processes will benefit from more predictable and reliable revenue and earnings results. And, as currency volatility and uncertainty continues to increase, they'll have the foresight and the agility to be able to adjust their risk policies and FX exposure management strategies to keep in step with the ever-changing dynamics of a global marketplace. ▲



Wolfgang Koester, CEO of FiREapps

Calendar

Seminars

Cash Flow ForecastingTechniques
San Francisco Dec. 10-11, 2008*
Orlando Mar. 10-11, 2009
New York City Apr. 28-29, 2009
For more information go to **www.AFPonline.org/CFF**

Advanced Cash Flow Forecasting
Dallas May 12-13, 2009
Chicago June 17-18, 2009*
For more information go to **www.AFPonline.org/CFF2**

Cash Management
Los Angeles Oct. 18-19, 2008 (Annual Conference)
San Francisco Dec. 8-9, 2008*
Atlanta Jan. 21-22, 2009
Orlando Mar. 5-6, 2009
Boston May 18-19, 2009
Chicago June 15-16, 2009*
For more information go to **www.AFPonline.org/cmseminar**

CTP Review
Charlotte Dec. 2-4, 2008
Bethesda, MD June 2-4, 2009
Toronto June 9-11, 2009
For more information go to **www.AFPonline.org/ctpreview**

Electronic Payments 101: Instruments and Processes
Orlando Mar. 7-8, 2009
New York City May 1-2, 2009
For more information go to **www.AFPonline.org/EPay101**

Financial Risk Management
San Francisco Dec. 11-12, 2008*
Orlando Feb. 21-22, 2009
Chicago June 18-19*
For more information go to w**ww.AFPonline.org/finrisk**

International Cash Management Strategy
Dallas Nov. 18-20, 2008
Las Vegas Feb. 4-6, 2009
Boston May 20-22, 2009
For more information go to **www.AFPonline.org/icms**

Treasury Risk and Loss Controls
Orlando Feb. 24-25, 2009
For more information go to **www.AFPonline.org/controls**
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Deadlines for CTP Exam – June/July 2009 Testing Window Standard:
March 27, 2009
Final: April 17, 2009

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