

## **The Market and Ten Year Treasury Rates**

### **The Burbank Group**

Over the past several months, we have watched Wall Street and the financial media go through the throes of financial prognosticating. In some cases, the latter group seems to have acted as shells for certain 'investor' groups, and provided platforms for certain individuals. Both have shown a surprising lack of knowledge and discipline in the explanation of financial and commodity markets.

In addition, the Federal government seems to have changed its role from protecting the domestic economy, bank depositors and the market, to protecting major financial institutions from their own mistakes, while allowing others to drive prices of commodities to unprecedented levels.

Only the bankers and financial institutions have acted in a manner consistent with past performance. Whenever they make a major mistake, they look for a bailout.

Why is all of this important to New York plaintiffs' attorneys?

- The use of the 10-year Treasury rate to determine discount rates has now achieved universal acceptance, not just for personal injury and wrongful death cases brought under Amended New York 50A.
- Insurance Carriers hold some of the exotic paper that Wall street has created, and any mark to market will reduce the value of investment vehicles that they offer and the reserves that they hold.
- Future damage Awards are usually developed using historically experienced COLA or inflation rates. Those rates may no longer be valid.

To understand whether and how the forces in the market may affect resolution of personal injury and wrongful death actions, it is important to understand those financial market forces.

### **Residential Mortgages**

Residential mortgages have a long history as conservative investments. Commercial banks seldom made them as they could earn more with permitted leverage than offered by residential mortgages. Commercial banks have requirements that essentially limit the loans that they can own, based on their equity and the type of Assets (mostly loans) they own. For this reason, banks have always looked to service income because that income does not involve any commitment of equity. When a bank sells mortgages it usually retains responsibility for servicing the mortgage, it charges a fee for those services and it gains collected cash float.

Initially, banks used Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage) to purchase mortgage obligations, but there were conditions and limits on these purchases. The mortgage amounts were limited, the mortgagor (property purchaser) had to provide some equity and meet certain

household earnings conditions. These agencies were still working out certain accounting and reporting problems.

Investment bankers sought to create a market or fill a need in the residential mortgage market, and seem to practice a corollary of Parkinson's Law. They have expanded the number of mortgage investment vehicles to fill the time of an ever expanding number of investment bankers.

Historically, mortgages were at fixed rates, with 20% down and the loans were limited to 2 1/2 annual income. At first, the mortgage investment vehicles included mortgages that were larger than the limits set on Fannie Mae and Freddie Mac, but followed the historical rules. The vehicles were extended to cover adjustable rate mortgages, then -0- down payments, and then those with limited or no verification of annual income. Finally, a number of mortgages very low initial rates (teaser rates) that very quickly moved up.

The resulting notes are often referred to as derivatives since they derive their value from other instruments (bundled mortgages). They are not normally held by ordinary investors but by institutions, like bank holding companies, Insurance companies, investment banks and pension funds. A number of these holders have leveraged their note holdings to produce higher returns (one organization apparently leveraged their investment 32 times).

For convenience, these derivatives can be classified as prime and sub-prime, and they can be further divided into interest only or principal only notes. There are different series of issues covering different types and bundles of mortgages. The downturn in these note markets started in the later sub-prime issues where little or no effort was put into verifying the ability to service the mortgage. (There is some indication that some mortgages were already in default when they were bundled.) As mortgage defaults and foreclosures started to rise, note values fell, those who leveraged their investment received margin calls and many of the markets for these notes dried up.

Before the fall, the availability of large amounts of financing helped to propel home prices to unprecedented levels which, of course, meant that borrowing was driven to new levels. In those States where real estate taxes are major financing vehicles, the rising prices resulted in a rising appetite for tax revenues.

As questions about the value of these mortgages arose, the stock markets began to reflect fear and uncertainty. Wall Street began demanding aggressive Fed action. And the Fed responded.

The CEO's of the originators of the mortgages, the bundlers of the mortgages and the holders of the resulting notes started down the old three step process.

- First, they announced that there was no real problem and, if there was a problem, it was containable. This first led to general euphoria on Wall Street.

Then they were forced to raise their loss estimates, and that led to the suspicion that these people had no idea of the extent of the losses.

- Second, they blamed everyone else. They blamed brokers, and mortgage originators for poor oversight. They blamed house flippers. They even blamed the mortgagee for borrowing too much, and failing to read and understand mortgage documents.
- Finally, they updated their resumes.

Banks, investment banks, insurers and pension funds that are coming up on interim reporting requirements are now being forced by their accountants to mark their note holdings to market. That has and will result in write down of these assets to some market level. The only question is what market level. These instruments are traded in a very select market, and that market has for all intents and purposes dried up. It was that lack of access that forced Bear Stearns to seek an accommodation through Morgan Chase to get to the 'window'. To that point, Bear Stearns had largely financed their portfolio through 'Repos' or repurchase agreements. In effect, these are demand loans or overnight money. In essence by going to the Fed, they have replaced one repo with another.

## **Government Actions**

From the start of this 'liquidity crisis', the Fed has been the primary government functionary and the Fed rates have been the primary vehicle in addressing liquidity. There are two rates that are used by the Fed. They are,

- Fed Funds Rate. Transactions cleared through the Fed produce short term overnight good balances, that banks loan to each other. Those funds are used to increase a borrowing bank's liquidity. The target rate for Fed Funds was lowered to 5.25% on 8/10/07. It now stands at 2.25%.
- Fed Discount Rate. The Fed will loan funds to participating banks by purchasing assets at a discount and with recourse when the participating bank goes to the 'window'. For a long time, going to the 'window' was a point of embarrassment for banks and seldom used. These recourse loans were supposed to be short term vehicles for increasing liquidity and bringing banks into line with Reserve requirements. The Fed discount rate was lowered to 5.75% on 8/17/08. It now stands at 2.5%.

These two distinctly different vehicles are often confused with each other in the media, as they were designed to serve somewhat the same purpose. The objective with each reduction in rate and target rate was to increase bank liquidity, and have that flow through the banks to borrowers. The Fed lowered the rates a number of times, seemingly at the direction of Wall Street.

The banks did what banks always do, they did not extend lending in a risky environment. The increased liquidity flowed into safe harbor investments.

The actions of the Fed are reminiscent of the old B westerns. The villain would shoot all of the bullets but miss the hero, and then he throw the gun without any attempt to reload.

The government also

- Enacted a rebate program for tax payers that will send out checks in the late spring or early summer. This seems to be designed to bolster consumer spending as home equity lines dry up, and credit card debt becomes limited.
- Reached an accommodation with Morgan Chase to permit Bear Stearns to access the 'window' without recourse to Morgan Chase, and with loans of a longer duration. (They then cajoled the sale of Bear Stearns.)
- Apparently, provided direct access to the 'window' for investment banks with loans of a longer duration.
- Apparently, expanded loans that could be acquired by Fannie Mae and Freddie Mac.

Now, look at what has happened!

- Major financial institutions start reporting enormous losses associated with illiquid and highly leveraged investments in mortgage-backed notes, through the application of the Marked to market rules.
- The dollar approaches or reaches record lows versus the Euro and Yen.
- Commodities (including oil) reach record price levels.
- Unemployment rises, and housing foreclosures approach record levels.
- Some elected officials propose a rollback of tax reductions and/or new taxes, and a new round of regulations for financial organizations.
- The 10-Year Treasury Yields fall below inflation. As investors engage in a flight to safety, the daily yields reached 3.31%
- The stock markets approach meltdown before achieving what some are hoping is a bottom.
- The media now entertains recession worries.
- Some mortgage marketers seek third party bail-out or acquisition.
- The sub-prime mortgage mess remains unresolved.

## **Oil and Other Commodities**

Demand for oil has been rising for years. Demand in Asia represents about 15% of US demand. There is no shortage of oil in the ground or short term refinery capacity.

There are temporary disruptions in operation when maintenance or changeover occur, but they are easily covered by excess supply.

While the media religiously reports the threats from rebels and demagogues, the supply continues. The only change is the continuing rise in price. If price were set purely by supply and demand, oil might be \$45-\$50 a barrel instead of \$100 plus. Oil futures are purchased and sold on margin (around 5%). There seems to be considerable effort devoted to forward purchasing to maintain current settlement prices.

The same threat reporting and pricing strategy seem to be extending to other commodities as hedge funds extend their positions. The only differences are that other commodities do not have a single organization that controls a large part of the supply.

Hedge funds were founded on the principal that they could take positions contrary to the current market movement and make money if they carefully chose the vehicles. Essentially they were often shorting a company or a market, and their positions were often highly leveraged. High risk makes these vehicles only for the sophisticated investor. These funds now hold substantial positions in all commodities, with oil leading the way.

The fascinating fact is that the sophisticated investors have included some of the same organizations that are invested in mortgage backed notes, including some public employee pension plans. Any substantial downturn in commodity prices could result in huge losses for these hedge funds and their investors. In at least some versions of Hedge Funds, the investors are responsible for the leverage, so that the losses may reach beyond the investment.

A downturn may well happen soon, even without intervention by CFTC (Commodities Future Trading Corporation), or any writer of a contract. CFTC sets the rules for trading and settlement, together with the option requirements. It is very difficult to maintain inflated prices in the face of falling demand without a reduction in supply. The supply of the major commodity is largely controlled by OPEC. They may not raise the supply of oil, but it isn't likely that they will lower it.

Many oil exporting countries use oil revenues to finance infrastructure with ever increasing demand. Since the dollar is the settlement vehicle and local currencies do not float freely against the dollar, the devalued dollar exports inflation to those currencies.

Oil prices are approaching the point where each price increase results in an offsetting demand reduction and a further weakening of the dollar, yielding no increase in real revenue, and in some cases a decline. The only way to increase revenue is to sell more at lower prices. That should result in a strengthening of the dollar and a more balanced price for oil. It may also push losses to any hedge funds that are long oil.

## **The Dollar and Treasury Notes**

As a general principal and in open markets, the relative value of one currency versus another is a proxy for the difference in inflation. The dollar has fallen to its lowest level since Euros began trading and to the lowest level in recent history versus the Pound, Yen and Canadian Dollar. That compels exporters to the US market to either raise prices or absorb increased costs. The dollar value reflects both the current commodity price rises and the long term and dramatically growing trade deficit.

The US dollar will probably strengthen from its current level as commodity prices and net imports fall, but will remain weak over the long term as there seem to be no programs to reduce the direction or size of the net deficit.

If dependence on imported energy is reduced, and/or an end is put to exporting service jobs and/or some of those jobs are brought back, the dollar may strengthen in the long term.

The 10-Year Treasury is the primary Federal financing vehicle. The yield on 10-Year Treasuries has declined over the last several months. The daily yield remained largely in the 4.50 to 4.99% range in 2006 and 4.50 to 5.25% range in the first half of 2007. The daily yield reached a high of 5.26% on June 12<sup>th</sup> of 2007. Since then it has declined. The daily yield on March 20<sup>th</sup> 2008 was 3.34%. Today, the yield is running at 3.5%. The last auction on March 17<sup>th</sup> was 3.51%.

The decline in yield is something of an anomaly, as it seems to be the result of a flight to safety, not a desire to accept that low level of income. There is too much uncommitted liquidity, and it is driving down all of the rates and yields. At this level, foreign purchasers may not be able to get any return on their investment, beyond somewhat protecting against devaluation of the dollar. Domestic investors will be in a similar position, as they will, to some extent, protect the purchasing power of the dollar.

## **Overall Economy**

The overall economy (everything except the financial sector, oil and commodities) has not changed materially until quite recently. Manufacturing jobs have been lost to changes in demand or foreign markets for the last half century, and the amounts of loss have been higher in other decades. Service jobs continue their wholesale departure from this country fueled by cheap international telephone service, lower wages, and non-existent benefits. Health care costs continue their extraordinary and

extraordinarily expensive rise. They are still driven by greed, overhead, unnecessary redundancy and government involvement.

Unemployment will continue to rise as financial market companies go through further consolidation as they try to mitigate operating losses. The pharmaceutical industry will continue to rationalize, consolidate and downsize operations. As governmental units are pressed, they will reduce employment, as will companies that market to consumer disposable income.

Importing will fall and exporting may benefit from the weaker dollar, if bank lending is available to smaller companies and is reasonable. Technology should continue to expand in both their corporate and consumer markets. Overall domestic demand should return as prices eventually reflect a fall in commodity prices.

This is not the first recession driven by financial market excesses, but it may be the worst. Any thought that a recession can be localized to the US is silly. The US economy is the premier consumer economy, the premier importer of goods and services. The economies of sections of India and China are driven by US disposable income, and a fall in the latter will result in a serious fall in those export economies.

## **General Conclusion**

As mentioned the mortgage backed securities mess has not yet been addressed, and it likely that the number of institutions reporting losses associated with Mark to Market and the size of those losses will increase.

When the mortgage mess gets defined, it will probably relate only to sub-prime mortgages and securities in which they are held. Once defined, a vehicle must be found to clean up the defaults and foreclosures. It would seem that the bundlers or their mortgage servicing agents should unbundle the notes and negotiate with the mortgagors. Foreclosure benefits no one, and foreclosure may not be automatic.

While the parties have not yet addressed this issue, they will either address it soon or suffer a long and painful recession. Other credit issues must be resolved or the banks will see more writeoffs, particularly in credit card and home equity debt.

Proposals for investigations, changes in taxes, changed regulations and new administration proposals will probably come late, cause needed action to be deferred and carry with them the rule of unintended consequences.

The actions to date are at best a Band-Aid, and one that doesn't stick well. At worst, it has given those who caused the problem a way to avoid the consequences of their actions, and deferred resolution of the problem. If the holders of the notes could find

no recourse, they would very quickly find a way to force the originators of these notes to resolve the default problems.

The alternative would be and is a succession of marking to market by the note holders. This will adversely affect earnings and retained earnings, and, for those institutions with dictated reserve requirements, shortages that could dictate a retrenchment in business or entry into a market to raise new capital. Pension plans may face the need for increased funding.

## **10-Year Treasury**

Outside of financing, market essentials seem to be in decent shape. This should lead to an early recovery. 10-Year Treasury rates and yields have probably and/or should start back up in a relatively short time. How far they will go, and whether and how far they will overshoot a balanced level is anyone's guess.

Barring further government action, a safe bet is that the rise will come soon. It will at least equal some sort of average auction rates and yields, plus a factor reflecting the rise in inflation. This will compensate for the weakness of the dollar. The alternative would be a flight to the relatively small Inflation Indexed Notes (TIPS).

The issue for plaintiffs' attorneys would seem to be whether and at what rate liability carriers can be induced to resolve open cases, if at all. The indexed rate is defined as the rate in effect at the date of the verdict. That has not been defined.

There are three rates. Each 10-Year auction carries a stated rate for the note. There is also an auction yield or the stated rate multiplied by the note amount divided by the amount paid for the note. Finally, there is the market yield which is function of what is paid for each note.

The following display lists average rates and yields as of March 17, 2008.

- All years incorporate all regular auctions since the effective date for amended 50A (July, 26, 2003)
- Two year includes the last eight regular auctions or update.
- One year includes the last four regular auctions or update
- Updated Yields incorporate an interim Auction yield on March 17, 2008 that is projected as the next regular auction yield. In succeeding weeks, the weekly yields are added a projected auction yield is calculated.
- Weighted rates and yields are calculated using an increasing factor for each auction or update. In this case, 50% is used. The first auction rate is factored by 1, the next by 1.5, the next by 2.0, and on.

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	Rate	Yield	Update	Rate	Yield	Update
All Years	4.39%	4.46%	4.42%	4.41%	4.49%	4.40%
2 Year	4.53%	4.42%	4.41%	4.61%	4.37%	4.23%
1 Year	4.25%	4.38%	4.08%	4.25%	4.13%	3.91%

Liability carriers are more reluctant than settle cases than usual, as they are faced with unprecedented increases in net settlement (cash outlay) resulting from the fall in Treasury rates and yields. They may also be facing Mark to Market requirements on notes that they may hold. When liability carriers last incurred losses in investments there was a howling about Med/Mal insurance increases, and a slow down in case resolution.