



Performance Capital Services Newsletter

***Organizing Complexity into
Execution!***

March 2008

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Dear Tony,

The objective of our newsletter is to provide strategic news and analysis for financial services and banking leaders regarding current and future market conditions, strategic positioning and execution as it relates to organizational strategies.

Quick Links Our Website

**[We have added an
expansive list of U.S.
economic indicators, key
interest rates, U.S.
consumer interest rates
and interactive charting!](#)**

The underlying assumption at all times is that the markets continue to become more complex, change faster, and require better thinking and aligned execution for companies to meet their goals.

Sincerely,
Tony Pallante

Forecasting

First, my apologies to our readers for our hiatus. As our newsletter objective is to forecast market conditions and adjust strategically within the context, I would like to review some past news and corresponding PCS Newsletter comments:

[New York Times July 19, 2007 "Comments from Bernanke Rattle Investors"](#)

"Investors sold off shares as the Fed chairman, Ben Bernanke, speaking before the House Financial Services Committee as part of the central bank's midyear forecast, said that the economy should strengthen into 2008 and that the risk of inflation remained the Fed's "predominant" concern. He also said the housing sector might get worse before it gets better - and remained a risk to consumer spending and overall economic growth."

[PCS July 2007 Newsletter](#)

"Since 9/11 the economy has been buoyed by defense and government spending, foreign investment and the housing boom. The Fed's interest rate policies have turned the boom again to bust, and foreign investments are shifting into equities, US Treasuries, and other countries. As a result the consumer spending momentum from the housing boom will wind down.

Note that I say will wind down. It has not yet reached bottom and the negative effects are not fully realized. An early indicator is the increase in consumer credit, revolving and

non-revolving, increasing both in March of 2007 and May of 2007 by 6.4% which are some of the highest quarterly numbers in 5 years. Equity extraction is now limited and consumers are maintaining spending through personal credit. Time will tell."

New York Times August 20, 2007 "In First Crisis on the Job, Bernanke's About-Face Is Weighed"

"On Aug. 7, Wall Street got its first answer. The Fed said in a statement that it was watching the housing meltdown with concern, but that it believed the broader economy was on a steady path of growth. The words did nothing to calm the markets."

PCS August 2007 Newsletter

"I wasn't going to comment on the Fed this month however I feel compelled to point out that the Fed is holding its benchmark rate to control inflation. On the other side they are adding liquidity to the market as of this writing by injecting reserves into the banking system. If this translates normally through the system it will have an inflationary effect. This is a bit like pumping the gas and the brake at the same time. It is not enough and they need to get off the brake and let the car get up to speed."

New York Times October 16, 2007 "Treasury Chief Aims to Steady Credit Markets"

"WASHINGTON, Oct. 15 - Two months ago, when credit markets around the world were freezing up in panic over failed mortgages, Treasury Secretary Henry M. Paulson Jr. said that he was confident investors would work things out for themselves.

We're going to work through this problem just fine," he said in an interview with CNBC on Aug. 21. "I think what the American people need to understand, these things take a while to play out."

PCS September 2007 Newsletter

"There is a difference between desire and will, between recognition and action, between caring and resolve. In each the difference is between observation and action, the difference between being a witness and being a participant. This is a time for leaders to display their will."

Market

Everyone is now an "expert" on the mortgage market with 24x7 coverage by the media. Pundits and officials finally realized that the issues are not "limited to the real estate market" and "wouldn't impact the broader economy" as they held in the middle of 2007 and now recognize the devastating

impact that Fed action/inaction coupled with our industries excesses have now had.

The key strategic strike points from now through at least Q1 2009 are:

- Recession; we are in one now
- Lack of confidence and liquidity in the credit markets
- Mark to market valuations at unsustainable levels for mortgages and soon, *consumer credit assets*
- Ongoing deterioration of the consumer condition:
 - Unemployment, labor force participation rates
 - Severely reduced equity extraction
 - Decline in asset values (real estate, equity, investment)
 - Declining disposable income, weak dollar, increased credit utilization and lack of access to credit
- Tightened regulatory controls including capital requirements that will restrict lending and force assets off the balance sheet

Strategic Implications

The government is and will be further forced into a complete industry bailout. While I disagree with this as the solution the fact is it is going to happen as it did during the savings and loan crisis (different type of crisis but the "owner of the problem" will be the same; the American taxpayer).

This is already in motion as lawmakers pass legislation loosening FHA programs and increasing FHA and GSE loan limits. The Fed is in a race to lower rates at a pace that exceeds its poorly thought out 18 month rise. The Fed has now opened credit the discount window to non- banks (banks it doesn't supervise) and will accept mortgage backed collateral that may be potentially illiquid and high risk. The Fed certainly had a hand in the Bank of America/Countrywide deal and overtly positioned the JP Morgan purchase of Bear Stearns agreeing to fund and manage up to \$30 billion in Bear Stearn's less liquid assets.

The Opportunities

Just as in the case of the savings and loan crisis, this government intervention will be funded by billions of tax payer dollars (the cost of the S & L crisis is estimated to be about \$124.6 billion paid directly by the U.S. government aka. the taxpayers) and frankly the margin in the "froth" of activity is going to be significant. Many players made their fortunes in the workout of assets and bank liquidation activity

during the Resolution Trust business era. As an example, congressional Democrats have proposed a bill providing \$400 billion in guarantees for troubled mortgages, if a lender has first written down the value.

Originators

Origination capacity has been severely curtailed. The remaining players are those with large balance sheets, or the small shops where a limited number of loans and low operating costs create some level of profitability.

It is also an opportunistic period for originators to forge longer term win-win relationships with lead providers while they are struggling through the same issues of reduced volume and profitability.

Originators should continue to scale back to profitability regardless of what size that might be and build competencies to leverage government backed programs. The visibility that we have on continued margin compression mandates maximizing the use of technology for efficiency in every process. A highly efficient, break-even or better originator can be poised to take market share when the market normalizes while their competitors take 6-8 months to tool up and/or re-enter the market. We have a very brief overview of our thoughts on this topic if [you click here](#).

Servicers

This is a critical time to deploy additional expertise, as operations are rapidly expanding loss mitigation efforts. This expertise would include:

- Data analysis and modeling to the same extreme used by small balance consumer lenders for continual forecasting and updating of portfolio risks and opportunities into defined categories.
- Profitability modeling for each of the defined categories to precisely manage the financial trade-offs of loss mitigation efforts such as loan modifications, workouts, refinance opportunities, cram-down and short sale limits, and foreclosures and REOs.
- Modeling to determine risk/reward of selling portfolio trenches even at currently difficult discounted rate where the potential credit risk, compliance risk and brand or external optics risks may be mitigated.
- Leveraging state and government resources that are being deployed at every level.
- Linking with internal or external retail originators to refinance early predictive trenches of the pool.

Banks

Many of the solutions are already in play in terms of writing down assets as far as possible, recapitalizing to shore up the balance sheet and reviewing and revitalizing risk management efforts. The Fed is obviously taking a strong position in protecting system stability through liquidity, loosened borrowing and collateral requirements and rate reductions for improvement in spread.

It is obviously a time to return to fundamental underwriting principles. Every institution should review their spectrum of lending products, and policies, keeping in mind that declining consumer conditions are going to put pressure on every asset class. There is a natural tendency to over balance these efforts which should be guarded against. Servicing operations in other asset classes should be analyzing and preparing for similar issues as those in the mortgage pool; a hard, honest analysis should be underway now. This is a time to sharpen deposit gathering operations and improve the customer experience throughout the firm to maximize customer retention at each end of the model.

[Performance Capital Services](#)

Performance Capital® Services ("PCS") is a strategic management consulting company specialized in helping financial services companies achieve results through strategic planning, modeling and implementation.

Our Strategy-Cycle-Strategy approach recognizes the requirement to set your business strategy, to integrate the plans into daily operations, to forecast the results, to monitor and measure the outcomes and to adjust the plans on a real time basis.

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