The Financial System Meltdown of 2008 – A Year Unlike Any Other (Hopefully)

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Last year saw massive financial disruption that reached beyond Wall Street to the "real" economy. The numbers best tell the story: over $30 trillion in worldwide stock market value has evaporated since the beginning of 2008, there is more than $1 trillion in underwater residential mortgages in the U.S and even seemingly the safest markets, such as the first lien loan market, are trading down to an average of 60%. Despite the dismal experience in 2008 and the outlook for 2009, the current financial situation is not unlike many downturns that have occurred throughout U.S. history, where easy credit helped fuel an asset "bubble" that eventually burst. As we begin a new year, a solid step forward is to recognize the issues that the financial community faces going forward and to identify some sources for optimism.

One challenge is the reshaping of Wall Street's investment banks from their traditional forms. Each of the five standalone investment banks that started 2008 have been forever changed – including bail out acquisitions (Bear Stearns and Merrill Lynch), conversion to bank holding companies (Goldman Sachs and Morgan Stanley) and a bankruptcy filing (Lehman Brothers). Apart from layoffs and declines in revenue, the changes to the standalone investment banks have altered Wall Street by drastically increasing the role of certain actors in the financial community, ranging from the Federal government, sovereign wealth funds and well-capitalized opportunists such as Berkshire Hathaway, each of whom have provided funding to distressed firms in exchange for preferred and other positions purchased on exacting terms.

Another challenge is a drastic decline in both investor and consumer confidence, and a concomitant downward pressure on asset prices. The recent experience with hedge funds is a prime example. Investors' initial concerns with hedge funds stemmed from perceived exposure to the subprime mortgage market. Investors' concerns were further compounded by sudden and unexpected limitations imposed on the financial markets, such as the federal government's ban on short selling, which limited hedge funds' ability to potentially minimize their exposure. And, of course, this occurred before the most recent shock of the enormous scope of the alleged criminality and fraud surrounding Bernard Madoff. As Warren Buffett once said, "you don't know who's swimming naked until the tide goes out," and it appears that many investors worry about what else is lurking in the water. As confidence lags, investors will likely continue to seek to redeem their money and exit from their investments in 2009.

A third complication is the virtual seizing up of the capital markets. The market for collateralized debt obligations, DIP financing, leveraged loans, high yield bonds, investment grade bonds and commercial paper each froze at various points in 2008 (and, in some cases, have yet to thaw). This has led to tighter credit availability and wider pricing for firms, downward pressure on asset prices and has left many service professionals with a lot less to do in 2009.

Another concern is the uncertainty surrounding other aspects of the financial community that appear to have weathered the financial storm fairly well in 2008, but which may have looming maturities. Private equity firms are a principal example. Many private equity funds hold investments that appear to be underwater at the present time because of a contraction in both purchase prices and debt multiples. Private equity firms, however, generally hold their investments for longer periods of time (as compared to hedge funds) and, due to the previous robust credit environment, bought assets on easier credit terms, including "covenant light" debt facilities. On this view, private equity firms have the benefit of time and the opportunity of waiting to see whether asset values rise. Many private equity firms, however, completed their deals using historically high debt and purchase price multiples that have now severely contracted. Thus, barring significant recoveries in asset values in the future, equity recoveries for these firms will be challenging.

Another example of looming risk is the commercial real estate market. Residential real estate prices in many parts of the United States continue to decline as compared to values in 2007 and 2008, and there appears to be the beginning of a downturn in commercial real estate prices for the first time since 1990 – 91. Many commercial real estate firms may be ill equipped to deal with a decline in real estate prices because many deals over the past year and a half were done as commercial mortgage backed securities, the market for which has shrunk drastically and which will leave many commercial real estate firms with obligations that are increasingly difficult to refinance in 2009. Additionally, as already experienced in the early weeks of 2009, risky assets continue to challenge bank's balance sheets.

These issues – the transformation of the standalone investment banks, the decline in investor confidence and the attendant decline in asset prices, the collapse of the capital market and the prevalence of firms with pressing maturities – support the thesis of many that 2009 will be a dismal year indeed.

There are, however, some sources for optimism. One source is the effect that large restructurings will have on the economy as a whole. We can undoubtedly expect a spike in the number of in court and out of court restructurings in 2009. There will likely be a premium on restructurings done in the most efficient way possible, preferably out of court or, if in court, with a focus on pro active planning done well in advance of a filing. Firms that are over leveraged but which are operationally healthy will be the most likely candidates for a successful out of court restructuring or a carefully crafted in court reorganization. Firms that need liquidity in the short and long term will be challenged for their very survival.

This is not to say that restructurings will necessarily be a negative development. In fact, they may be positive in the long run because restructurings could lead to a de leveraging of many firms' balance sheets and the re-emergence of more conservative capital structures. Such de-leveraging will likely be at the expense of the lower level of firms' capital structures, as holders of equity and subordinated debt are wiped out, but could create companies with healthier capital structures. Indeed, a recent study of large bankruptcies over a recent 12 year period suggests that chapter 11 generally achieves its stated purpose by preserving going concern value of financially distressed firms and redeploying the assets of economically distressed firms[1]. This suggests that even if the U.S. experiences a large number of bankruptcies in 2009, the bankruptcy process may help over-leveraged firms to reorganize or to re distribute their assets for the greater economic good.

Another source for optimism is the effect of the Federal government's efforts to intervene. The most recent example is the Troubled Asset Relief Program (TARP). The original idea behind TARP was for the Federal government to take bad assets off banks' balance sheets. In actuality, TARP followed the U.K. approach by providing cheap forms of new capital to financial firms with risky assets. One problem with this approach, however, is that those firms, although recapitalized, still have risky assets on their books. But the jury is still out on the effectiveness of TARP. The law continues to be reviewed and, given the Bush administration's decision to permit the incoming President a say in how the remaining $350 billion will be used, it is entirely possible that TARP will be re deployed and have a positive net effect on the financial community. Additionally, President-elect Obama's financial recovery plan, which contemplates significant public spending, has the potential not only to alleviate stress on the economy in the short term, but to improve the U.S.'s infrastructure for the future.

It is also important to maintain perspective. Many companies will weather the storm without restructuring. Additionally, despite the near-hysteria concerning the subprime residential mortgage market, it is important to remember that virtually 95% of residential mortgage holders in the U.S. continue to pay their mortgages on time.

Economic recoveries, like recessions, do not happen overnight. Of course, knowing if, when and how an economic recovery will be had is entirely unpredictable and, given past trends, we likely will not recognize one has occurred until well after it has come to pass. Over the course of U.S. history, there have been numerous economic busts and recoveries, and although there will be some pain as the economy recovers, it is worthwhile to focus on the sources for optimism, including the availability of a viable restructurings framework in the U.S. and the fresh policies of the incoming administration.

1 See Michael L. Lemmon, Yung Yu Ma and Elizabeth Tashjian, Survival of the Fittest? Financial and Economic Distress and Restructuring Outcomes in Chapter 11 (January 1, 2009). Available at SSRN: http://ssrn.com/abstract=1325562.