clearwater ADVISORS

MARKET Commentary

The People United Will Leave the Banks Divided

April 2010

"We may be adversely affected by increased governmental and regulatory scrutiny or negative publicity."

-Goldman Sachs & Co. SEC Filings 10-K, Risk Factors, 12.31.09

With the public outrage over the government's handling of the credit crisis still riding strong, Congress and the Obama administration have pressed forward with legislation aimed at overhauling the financial industry. The populist movement has gained the attention of Wall Street, and Wall Street would be wise to listen. Goldman Sachs, in their most recent quarterly SEC filing, listed "negative publicity" as a key risk factor to its business—the first financial institution ever to do so.

The proposed legislation would limit government's ability to support financial companies and could have significant ramifications for an institution's funding ability, business model and growth strategy. If passed, the legislation could lead to a series of downgrades among many of the world's largest financial institutions. **In an extension of last month's market commentary, we reemphasize the need for investors to monitor potential credit risks closely both in their portfolios and banking relationships.**

The House and Senate Proposed Legislation

The House passed the *Wall Street Reform and Consumer Protection Act of 2009* on December 16, 2009, and the Senate bill, *Restoring American Financial Stability Act of 2010*, dubbed "the Dodd bill," has come out of committee and will likely be brought to the Senate floor in April. The two bills are philosophically similar, which should streamline the reconciliation process between the bills. Senate Democrats have indicated that they would like to push this bill through the Senate before Memorial Day.

Proponents of financial reform legislation seek to do the following:

1. Create a risk council to oversee institutions that are deemed systemically important
2. Provide for an orderly wind down of systemically important failing institutions
3. Regulate and separate certain proprietary trading activities of regulated institutions
4. Regulate the Over-The-Counter (OTC) derivatives market

Figure 1: Difference between the House and Senate Version of the Bill

	House Bill	Senate Bill
Liquidation Fund	$150 Billion	$50 Billion
Bondholder Concessions	Mandatory haircut for secured lenders in the case of a wind-down scenario	Any government claims to recover wind-down costs are senior to secured bondholders
Proprietary Trading	Nothing Specified	Includes the Volcker Rule, limiting certain proprietary trading activities of regulated institutions

To limit the cost to taxpayers, the proposed legislation limits the government's ability to bail out troubled institutions by keeping them on life support for an indefinite period. It would ultimately do away with a Lehman-type bankruptcy as an option for systemically important

US Treasuries

As of 31-Mar

Benchmark	Yield
3 Month	0.16%
6 Month	0.24%
2 Yr	1.02%
5 Yr	2.55%
10 Yr	3.83%
30 Yr	4.71%

Merrill Lynch Indexes

26-Feb to 31-Mar

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.15%
1-3 Yr Municipals	-0.28%
1-3 Yr Agencies	-0.16%
0-3 Month UST	0.01%
S&P 500	6.03%

Contact Us

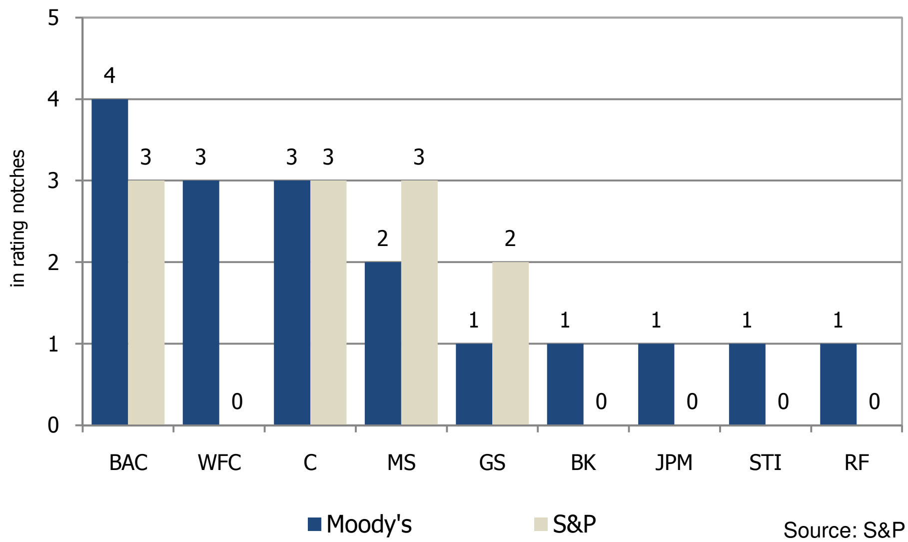
www.ClearwaterAdvisors.com
Trading@ClearwaterAdvisors.com

Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan institutions. In contrast to the regulatory environment before the Lehman bankruptcy, regulators will now have the proper authority and protocol to wind down financial companies and non-bank subsidiaries if a merger cannot be arranged. The cost of this wind down is to be covered by a liquidation fund, built up through a financial tax on the nation's largest banks. This liquidation fund will be used to limit the amount taxpayers could potentially be forced to contribute. Under the new guidelines, government claims will be senior to all creditors including senior secured bondholders, giving an added layer of protection to the taxpayers.

Rating Agencies Take Notice

Standard and Poor's and Moody's have been vocal concerning the effect that this legislation could have on the ratings of the largest financial institutions. Many financial institutions currently receive several notches of ratings uplift based on the implicit support they receive from the government. S&P and Moody's have warned that the bill would limit the support that the government would be able to offer struggling institutions forcing them to reconsider the ratings and potentially lower them by the amount of the current uplift. The institutions that would be most affected are Bank of America, Citigroup, Wells Fargo, Morgan Stanley and Goldman Sachs.

Figure 2: Ratings uplift enjoyed by select financial institutions given current implicit government support



Source: S&P and Moody's

For corporations who either hold securities or bank at these institutions, questions over their counterparty risk should roughly follow the progression below:

- **Will the long-term ratings be downgraded?**
- **Will the short-term ratings be downgraded?**
- **Under the scenario of an orderly wind down, what effect will this have on bondholders?**

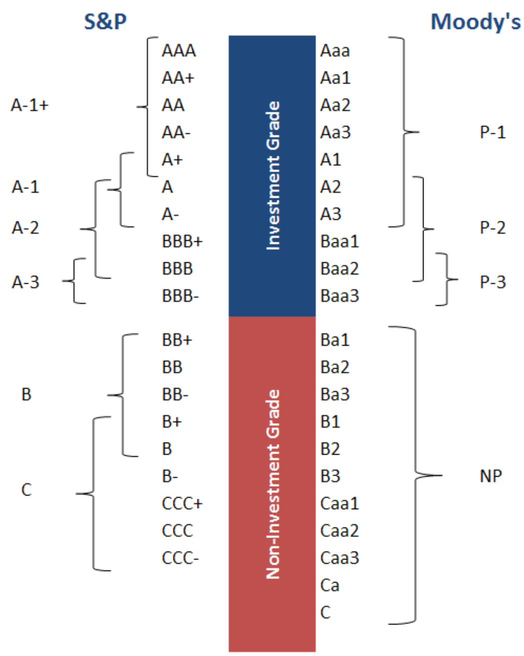
How Does This Affect You?

We fully anticipate that the rating agencies will downgrade the long-term ratings of select institutions if the proposed regulations become law. We do not, however, think that the long-term rating downgrades will be as punitive as S&P and Moody's had originally outlined. Upcoming quarterly earnings announcements will shed further light on the steps banks are taking to strengthen their balance sheets and capitalization ratios. This will be crucial in convincing the rating agencies that these institutions can sustain their operations without government support in the case of an adverse market event. For investors who are sensitive to downgrades, the impact of the new regulations must be given serious consideration.

The magnitude of the long-term downgrades, if they occur as we predict, will largely dictate whether action will be taken on an institution's short-term ratings—in our opinion, a much more significant event. The possibility of such an event means that investors should proceed with caution, and consider minimum rating requirements for short-term investments and banking relationships.

When an issuer loses its top-tier, short-term rating, it can have a detrimental impact on its ability to access the credit markets. This can be particularly devastating for banks that borrow heavily in the short-term funding market, straining liquidity and drastically affecting their funding mix. A short-term rating downgrade may lead to margin calls and additional collateral requirements for other types of secured and non-secured borrowing. The higher funding cost will put pressure on net interest margins, affecting the firm's overall profitability.

Figure 3: S&P and Moody's guidance on the relationship between long- and short-term ratings



Source: S&P and Moody's

According to current guidance given by the rating agencies on the relationship between long- and short-term ratings, several institutions are already on the cusp of a downgrade to a Tier-2 rating. Both major rating agencies indicate that a Tier-2 rating could be assigned with a long term rating as low as mid-single A; in other words, A2 as assigned by Moody's and A as assigned by S&P. Even with the ratings uplift, Bank of America (A2/A) and Citigroup (A3/A) are already in a delicate position. Tier-1 ratings typically cease to be assigned to companies that fall below a long-term rating of single A. A modest one- to two-notch downgrade will bring both institutions into triple B territory. The rating agencies would be hard pressed not to downgrade the short-term ratings of Bank of America and Citi to A-2/P-2 if this occurs.

The new bill will also add risk to secured and unsecured bondholders in the case of a liquidation scenario. The new legislation will require secured bondholder claims to be subordinated to any government claims accumulated in assisting a troubled institution. This new seniority in claims results in less collateral and assets for secured and unsecured bondholders. The new regulations are aimed at encouraging responsible lending and forcing bondholders to participate in the cost of unwinding a failed institution.

Looking Forward

Progress and passage of the new financial regulation will be keenly watched by the bond market. While the economic picture continues to improve at a modest rate, unknowns, such as the new legislation, reiterates the importance of prudent credit risk management. For more information on the proposed regulation and its potential effect, please feel free to contact our desk.

Form ADV Part II

Clearwater Advisor's annual Form ADV Part II disclosure is available to clients upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call Brittany Pfister at 208-489-7550.