

The Meltdown

These are unprecedented times for many of us. Housing, banking, investments and insurance, small business, tourism, newspapers, service companies, technology, the auto and other major industries, the swelling ranks of the unemployed – no one seems to be escaping this recession unscathed. Conventional thought points to overbuilt housing, over-sold mortgages and deregulated – or is it unregulated? – financial markets as culprits of this crisis. ¶ The MADDUX BUSINESS REPORT sat down not long ago with Tom James to get his take on the matters at hand. And to get a peek into how the chairman and chief executive officer of Raymond James Financial (RJF) is negotiating his own house through this crisis. James may be conservative in his general approach and outlook, however he's anything but conventional. ¶ Over the course of its nearly five-decade history, RJF has grown from a door-to-door, stock-and-bond shop to one of the nation's preeminent regional brokerage houses, generating net revenues in fiscal 2008 of \$2.8-billion and \$235-million in net profit. The brokerage firm now is converting to a full-service bank holding company, a process that may be completed by the time this is published. ¶ James joined his father's firm in 1966, fresh from Harvard Business School, and has been the guiding hand through its growth almost ever since. Its stock peaked last September at \$38.25 and now seems to hover in the low to mid-teens. ¶ As this conversation unfolds, keep in mind that James met with reporter Catherine Russo Cobb way back in January, around the time of the change in this nation's administrations. We thought a lot had happened between September and then; well, even more has happened between January and now. The following has been edited for space and clarity.

>> **Maddux Business Report:** *Just why do you think this financial meltdown occurred?*

Tom James: A confluence of factors. The one that gets the most attribution is the subprime crisis where a combination of lax standards in the underwriting process and demand by customers – supported by government sponsorship of more home ownership – lead to a lot of issuance of subprime debt.

What are some of the other factors?

TJ: We had a bubble building in virtually everything ... but certainly in housing prices. There was a lot of speculation, particularly in condominium markets where people would flip deposits. The demand forced up construction costs, reinforcing the price increases. Everybody believed they would get bailed out by continuing price increases, but history tells us that never happens – you have bubbles, breakdowns, and then corrections in the marketplace.

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Since to a certain extent this is history repeating, why did this go so far this time?

TJ: There is plenty of blame to go around. Give it to the buyer who didn't pay enough attention; give it to some of the lower-end mortgage issuers who fabricated data. There's been a lot of focus on the rogue mortgage brokers, but I would tell you the quality of standards at major institutions competing to get their share of the market – no one stuck to the old-time religion of high quality underwriting.

That led to a crisis when subprime loans increased from 3-5 percent of mortgage issuance to 30-35 percent. And it took everybody's cooperation – the ratings agencies, the government, buyers, investors buying the mortgages in pool form without doing much due diligence. It was difficult to ascertain what the level of problems really was because you couldn't value these pools.

Why couldn't you?

TJ: Because no one knew which particular loans (good or bad) were inside the pools, so they all went down. As things got worse, there were fewer and fewer bidders – everyone was a seller – and the prices just went through the floor.

In fact, they went far below rational pricing. The prime loan people started to worry about those, and the next thing you know it was credit card loans and auto loans. Banks historically imposed more discipline. But suddenly everyone said, "No terms and no conditions, don't ask a lot of questions." That was mostly because there were buyers who put the mortgages in a pool and sold them; then said, "It's not my problem."

This does seem to go against the grain of conventional wisdom ...

TJ: You have to stick to the tried and true in any industry, and banks get reminded of these old tried-and-true rules about every 10 to 20 years. You know you have a problem in the real estate business when your neighbor is becoming a developer. Or making more money flipping deposits from condos than he's making in his base job. That's a sign of excess.

To what degree had Raymond James invested in subprimes?

TJ: I think it's less than \$25-million.

How much leverage did some of the houses like

Bear Stearns and Lehman Brothers have? What were their debt-to-equity ratios?

TJ: They had 30 to 35 times leverage factors.

What do you have?

TJ: Ours is more like 9 or 10 times, and that's only because of the bank (Raymond James Bank, an RJF subsidiary). If you subtracted the bank out, our ratio drops to approximately 7.5 times.

Has the government made the right moves in this crisis?

TJ: The Treasury Department, the Fed, the FDIC leadership have generally worked extremely hard, very rapidly in addressing the problems. You get so much misinformation from the press, because of ignorance mostly, and even so much more from our politicians who aren't well educated financially, that it's disturbing. The complaints are ill-founded – sure they made mistakes; sure they might have done something differently in retrospect, but we were dealing with an unprecedented economic crisis and you couldn't spend two years debating this.

The government will make money on the \$350-million first phase of TARP (Troubled Asset Relief Program). It has its arms around the financial crisis, but that doesn't mean you are through with support payments ... we are going to have a second wave of problems. I am encouraged that we are doing the right things.

There clearly are more problems than financial ...

TJ: I didn't think I'd have another one of these in my lifetime. We have a difficult economy added to the financial crisis, so we essentially have a dire economic situation not dissimilar to the conditions that existed in the early '70s.

The demand that was in China and India and other emerging countries has been squelched ... They are now dropping dramatically, and our demand has gone negative so this is going to take a while to work out.

How long?

TJ: I think it's logical to assume that it will take all of 2009 to bottom out. Because we had this massive amount of overleveraging in our whole system, people are now being careful about how they are spending money. Businesses that were wildly making loans are now being careful. They are holding back both on capital expenditures and hiring new people. The housing

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crisis, for historical comparison, really requires until mid-2010 to work off excess inventories. This is providing we don't have further disruptions of great magnitude.

Are any opportunities being created?

TJ: You get great opportunities in buying the stock market and assets. Things do change, and you want to keep your eyes open for the opportunistic side as well as the negative side. While I generally describe myself as a paranoid, I certainly want to look at the glass as half full, too ... so that I know that the firm is taking advantage of opportunities as they are presented.

Is anyone doing well, all things considered?

TJ: The good regional banks in the U.S. are pretty well capitalized and are making loans. They are being very careful. And they should be careful – they just had their hands burned! It takes some time to regain confidence and it takes a while for conditions to improve generally.

We need to have some balance in terms of the reporting. You read a lot about BofA and Citigroup, but not about BB&T, US Bank and Regions and other strong banks that continue to make loans available in their marketplace and are doing a good job.

Did RJF apply for the TARP funding and the temporary loan guarantee program?

TJ: We applied for TARP financing, like all financial institutions of any size, and for the temporary loan guarantee program. We didn't get the temporary loan guarantee program because the interpretation by the FDIC was that you couldn't get one as an S&L holding company, but you could get one as a bank holding company.

We didn't know how long it would be to get TARP funds, so we got the extension of \$100-million (in a credit line) we thought would carry us forward until other options became available.

Do you even need the TARP money?

TJ: We are very conservative and we have enough capital to run our business successfully. We still anticipate we will get TARP funding and we anticipate we will get the temporary loan guarantee program after our conversion (to a bank holding company, which should be at the end of the first calendar quarter 2009). We should hear in the near future whether we are approved for TARP. We filed as a placeholder and never indicated that we would take some or all of any award because capital requirements at the time would determine whether we would accept them.

Will the \$500,000 cap on bank executive pay proposed by President Obama affect whether Raymond

James will accept the TARP funds?

TJ: Compensation issues won't impact the decision, but some of the public perception issues of a "bailout" might.

The purpose of the CPP (Capital Purchase Program) component of TARP is supposed to be to improve the ability of successful financial institutions to lend – not to save them – with the exception of several "too-big-to-fail banks." We aren't happy with either the press' perception of this process or the public's. A preferred shareholder, even the government, doesn't have the right to manage a corporation. We are already expanding both mortgage and corporate lines without funds and would expand at a greater rate if we elected to take them.

Why convert to a bank holding company now?

TJ: Actually, it was always a plan to convert when times were appropriate. Thirteen years ago the only way a securities firm could have a bank was to buy an S&L charter and get marketing exemptions. We were going to invest in mortgages or public mortgage securities and make a favorable return on our investment, but after the market changed a little bit, we got to be a more active originator of commercial loans.

And that's worked OK?

TJ: We underwrote every single loan. We didn't buy any pools that we didn't first evaluate the underlying securities of whole loans. So we largely avoided the problems going on out there and to date, knock on wood, we haven't experienced problems in traditional corporate lending. We have plenty of depositors, we don't need to change our status; it's not being done for that purpose like some of the other banks.

Why is it being done then?

TJ: Our strength is our knowledge of corporations. We underwrite their equities, we serve as their strategic advisors, we provide research on all of these public companies, and we know most of the private companies of any size. Consequently, we wanted to use that expertise to lend in bigger pieces than you can in individual loans.

Five years ago we did a very thorough analysis and made the decision that we could last two or three more years as a savings and loan. We planned to do it (convert to a bank) the third quarter of 2009, and when all of these problems developed we decided to accelerate it.

Your stock has taken a sharp drop from last year.

TJ: Well, it hit a high last year in September of \$38.25. The stock went to 12 and a fraction then back up to over 20, and now it languishes. It's been penalized because of related financial stocks. Because of the outlook for earnings for our company and for every financial services company, it's not as good as it was. It just so happens that ours is going to be a lot better than our peer group, generally speaking.

Where do you think the stock price should be?

TJ: I don't like the stock price here. It's below book value, which it hasn't been in 25 years. The earnings will out ... we are a stronger firm today than we were when the problems started. Even though we are being cautious about expenses, we are hiring high quality people. Our fixed-income department is stronger than it has ever been, too. I am actually getting pretty optimistic about the long run.

Have you maintained your own personal stake in the company? Have you sold any stock?

TJ: Oh yeah, I've kept it. Why would I sell it at these prices? ●

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