Managing Through A Prolonged Downturn

by Patrick J. McKenna

There is a rather tasteless joke that claims that a recession is when your neighbor loses his job, but a depression is when you lose yours. The curious irony is that economists have no specific point of reference to distinguish when an economy moves from one state of malaise to the other. That said, I think most people would agree that this economy is definitely in a recession. The question then becomes: how long will this last?

Conventional wisdom, publicly espoused by a number of market watchers and legal consultants is that: *"The recession will be intense, but short. Everyone wants to get back to normal. Short term, the backlog of real estate will be sold as owners accept losses; banks will end the credit crunch; layoffs will make companies more efficient."*

My view is far little less confident. I believe that unlike past experiences, this recession isn't being caused by a downward spiral in a few isolated industries. It started with the burst of a protracted housing bubble and then metastasized into a full-blown credit crunch, eventually destabilizing the entire financial system. Therefore, I submit that *for the next five years, every time you think it's safe to get up and dust yourself off from this downturn, every time you feel like you've endured the worst of it, another piece of news is going to come along to freshly bludgeon you. This time the economic slowdown is going to be a lot different and, in many ways, a hell of a lot tougher.*

Whether I'm right or wrong is probably immaterial. What is relevant is whether your firm is prepared for a worst-case scenario. What is worth acknowledging is that this economic downturn could present an opportunity to introduce meaningful change, when change is not normally an easy subject to discuss among partners.

To that end, I had the opportunity in meeting with the Executive Committee of a 650-attorney firm to include as part of our agenda, a specific exercise designed to engaged the group in creatively exploring what their world might look like, and what specific strategies and direction the firm might pursue, if this really was a recession of some magnitude and duration. The exercise consisted of presenting the group with a summary of 12 danger signs that I've been tracking and that collectively would suggest that this is likely to be a severe recession – followed by a questionnaire for each of the partners to share their candid views and suggestions. At the meeting itself I engaged the group in a meaningful discussion on what specifically they might do in anticipation of this economic downturn really lasting as long as 5 years. The discussions were spirited and the resulting action plans thoughtfully conceived.

When it is business as usual and the fees are rolling in, there's no real sense of urgency about actually changing anything. Think about incorporating the possibility of a long recession into your strategic thinking. Instead of merrily assuming that everything will turn back up in a few months and healthy growth will again be the norm, build assumptions around how to manage in a prolonged recession as part of your immediate planning. Most firms show a startling lack of forward planning for changing economic cycles.

Here is the exercise I conducted and would recommend for your next internal meeting:

WHAT IS LIKELY TO HAPPEN NEXT

(Twelve danger signs that when considered collectively could indicate that this recession may be far more severe and prolonged than one might expect.)

1. This residential mortgage fiasco will continue

Everyone has heard more than enough about the dangers of subprime mortgages; but there is even further danger from the least-known mortgages, called pay option mortgages. The pay option ARM mortgage allows a borrower to pay a minimum monthly payment. There are an estimated $500 billion of these loans, 60% in California. They are now about to come due. The mandatory trigger points for increasing monthly payments will start the default process rolling in the second half of 2008 (read that to mean: NOW!) The first re-sets are beginning and will escalate, month by month, until August, 2011.

In 2008, 1.69 million homeowners will lose their houses. A wave of unstoppable foreclosures is expected to hit the housing market for three to four more years, accelerating month by month. Rod Dubitsky, managing director for asset-backed securities at Credit Suisse thinks that 3.6 million more foreclosures could pile up through 2012. Unless the government artificially props up home prices, they will continue to fall to their natural level of equilibrium.

2. Causing consumer spending to decrease

The fear of what massive foreclosures have done to the economy has led Americans to cut back on all spending. For the first time in a decade Americans have actually reduced borrowing. The problem is that with every American cutting back simultaneously, an economy that is totally dependent upon Americans spending more than they earn, will implode.

Consumer spending drives *70%* of the U.S. economy. Without it, we are in deep trouble. Yet that's exactly where we are headed.

3. Then get ready for the next real estate disaster

The enormous cutback in spending by consumers will reverberate throughout the economy. Thousands of retailers and restaurants that expanded based on debt-aided demand will be going out of business. So, if you are sick of hearing about residential mortgage problems, there is yet another potential real estate crisis on the horizon – in Commercial property.

Those generous banks who gave loans to unqualified homeowners also provided the funding to support the grocery marts, fast-food restaurants, gas stations, theatres and strip malls that sprung up all around those new subprime boomtowns. But with foreclosures hitting 37-year highs and the glut of unsold property having now left millions of U.S. houses completely empty, few are left shopping at the strip malls –

so these businesses are closing shop.

In the interim, real estate investment trusts (REITs) that deal in commercial property have gotten slammed and expected to fall even further. The cost of commercial mortgages has soared, in lock step with the rise in subprime defaults. Bloomberg says we could see the worst drop in commercial property since the 2001 recession. Morgan Stanley is calling for a 15% drop over the next two years.

4. Followed by even further bank failures

The shoe that hasn't fallen yet is that small regional banks were the major lenders to developers. The bankruptcies of developers will lead to the bankruptcies of hundreds of small banks.

During the real estate bubble, a lot of regional banks were shoved aside in the mortgage market by companies like Countrywide Financial. So how did they get their piece of the action? By lending money to builders and land development companies instead. Five years ago, FDIC-insured banks had a portfolio of $257-billion in construction loans. Now it is $627-billion, and more of them are starting to go soar.

5. And higher unemployment

The current unemployment rate, as calculated by supposedly authentic Government statistics is 6.1%.

Highly leveraged mall developers and commercial developers will go bankrupt as their tenants stop paying rent. These bankruptcies will lead to a dramatic jump in unemployment. The negative feedback loop nature of this crisis will lead to unemployment rates of 8% to 10% or greater, by the time we reach the bottom.

6. Resulting in credit card debt escalating

Since 2003, household debt is up 24%. Nearly *half* of all American households have made it a habit to spend more than they make each year.

If you examine the subprime scenario in all its ramifications, you find that when house mortgages went bust, millions of Americans could no longer draw off home equity to pay for the newest flat-screen TV model, the vacation trip to Florida or other essentials. So they turned to the convenience of their credit cards.

Millions of house-broke or unemployed Americans have stopped paying off their credit balances. Just like defaults on mortgages, defaults on other consumer credit are expected to soar. Credit card debt has now hit a record $915 billion. And that's just the start. Total consumer debt stands at a mind-blowing $2.48 trillion, more than the entire United Kingdom's GDP. Card issuers like American Express, Citigroup, Capital One, Bank of America and Washington Mutual are already bracing for a 20% explosion in credit card defaults over the months ahead.

But here's the really scary part: just as they did with mortgage debt, banks and other credit card issuers have "sliced" up all those credit loans and sold them back to Wall Street. And then Wall Street sliced them all up again, packaging them as "safe" debt and sold them to the people who run our retirement funds. Ouch!

7. Brace yourself for U.S. general accounting rule "FAS 157"

This is the regulation that now says banks can no longer hide what are called "level three" assets. What's a "level three" asset?

Stocks, bonds and all the investments you've already heard of are what are called "level one" investments. "Level two" includes some of the less-traded mortgage-backed investments that started blowing up late last year. (The five biggest brokerage houses and the biggest universal banks — Citigroup, J.P. Morgan Chase and Bank of America — have over $4.1 trillion of these level two assets.)

But here's the biggest risk. At the top tier — "level three" — you've got the hidden investments that almost never trade. These are the huge derivative positions, the private equity investments and enormous slices of the mortgage market. Banks don't talk about them. The market doesn't put a price on them. So the only way for accountants to figure out what they're worth is...to guess. It's called "mark to model" pricing. It means each firm can basically set the value of its own assets, using its own formula. Kind of like "deciding" how much your bank account, your car or your house is worth, but without asking anybody to check your math.

And that's exactly the problem. Until recently, financial firms could pretend those hidden assets were worth plenty. But with law "FAS 157" cracking down, that's getting harder. Especially since many of these hidden "level three" assets are based on failing subprimes, collapsing lenders and defaulting consumer debt. When the public finds out just how many hidden "level three" investments are worth nothing close to what the banks have said they're worth, brace yourself. Because the bank losses that have rattled Wall Street already will feel like a day in the park.

8. While the costs of the financial rescue will continue to escalate

In addition to capital infusions in US Banks, the government announced that it would temporarily guarantee $1.5 trillion worth of new debt issues by banks as well as insuring another $500 billion in deposits. All in, the potential cost of the total bailout package is coming closer to exceeding #2.25 trillion – triple the size of the original rescue package which centered on buying distressed assets.

Governments will continue to pump hundreds of billions (they do not have) into an insolvent banking system. These actions will have dramatic unintended consequences (known as hyper-inflation). And all of this does not include a parallel bailout of the Financial sector and other industries through a series of obscure tax breaks that is expected to add billions of dollars to the federal government's deficit.

Meanwhile, the domestic automobile companies (employing 600,000 line workers

and another 3.6 million people indirectly) are currently looking to Washington for their own bailout. It has been estimated that if an automaker declared Chapter 11, taxpayers would be on the hook for billions in retiree benefits from that company.

9. Then there is the obscure world of CDS's

The October 13th issue of ***Fortune*** warns that, *"the financial crisis has put a spotlight on credit default swaps – which trade in a vast, unregulated market that most people haven't heard of and even fewer understand."*

CDS's are the fastest-growing major type of financial derivatives. They are complex financial instruments originally designed to protect lenders if a borrower should fail to make their debt payments. They have since played a central role in our unfolding financial crisis by proving 'insurance' on risky mortgage bonds – which ostensibly allowed companies to feel safe by passing the risk down the line. Unfortunately the federal government shied away from any oversight of CDS, allowing for giant financial institutions to be insured by and expect to collect money from unregulated *"institutions only slightly more solvent than your average minimart."*

Since the mid-90's these privately traded derivative contracts have grown into a $54.6 trillion market (the European banks wrote a staggering $426 billion worth of CDS's with AIG in 2007 alone). After emphasizing that CDS's enabled reckless behavior, that the risk exposure here is in the trillions with a capital 'T,' and that as recently as a year ago, there was $1 trillion worth of swaps that were unsettled among counterparties, the authors of ***Fortune*** ask – will this be the next disaster?

With approximately $55 trillion of derivatives outstanding in the world, no one knows how much is at risk. There is no formal system for handling these instruments. If these derivatives continue to implode, no country in the world has enough money to prop up the system. Very smart people are extremely worried about this possibility.

10. The coming wave of corporate bond defaults

A number of prominent investment firms are also now warning that high-yield, high-risk U.S. corporate bonds are likely to deteriorate in the coming months, as the market prices in expectations for more corporate defaults. Now that the corporate junk bond market has grown to $1.3 trillion, the likelihood of significant defaults cannot be ignored.

The cost of protecting high-yield, high-risk corporate debt from default becomes more acute amid concern that hedge funds are being forced to liquidate as the financial crisis depresses asset prices and investors withdraw

One of the effects of any wave of defaults is that is makes a recession last longer – by heaping more bad news on a market whose faith in credit ratings is already impaired.

11. Massive Increases in government debt at all levels

Federal, state, county, and local governments did what they always do. They extrapolated the tax revenue they were receiving during the housing boom years. Their current spending far outreaches the revenue that is coming from taxes. 32 states will have a combined budget deficit of $50 billion this year. It will get worse in 2010. California is already begging for $7 billion from the Treasury. New York State and City have been dependent on Wall Street tax revenues. They will get $0 from these firms going forward. Citizens will not be happy with tax increases during a recession.

Concurrently, over $6 trillion of stock market value has been lost in the market during the last year. For those who are retired or close to retirement, their future has been devastated. The time when the baby boomers (76 million baby boomers all plan to retire over the next 10-15 years) start adding big time to government spending (medicare and social security) is fast approaching. But, the US has $53 trillion of unfunded liabilities and a national debt of $10.1 trillion. How is it going to cope?

12. And the expanding U.S. trade deficit

With the trade deficit now running at $750 billion per year, and much of that money coming back into U.S. Treasuries, the U.S. government has grown dependent on foreigners to sustain the continuing deficits. That level of debt would normally cause extreme weakness in a currency – just as it would in the value of debt owed by a deeply indebted individual. However, the sheer magnitude of the foreign holdings provides something of a bastion against a total collapse in the dollar.

Even so, some foreign holders are easing toward the exits . . . through the purchase of an operating company or resource deposit here, or a landmark New York building there. They might make a billion-dollar equity investment in a brand name company, or exchange some dollars for a basket of currencies or a ton or two of gold. It’s a delicate balancing act, because if they get too aggressive, they risk triggering a mad dash for the exits, a nightmare scenario where the value of their trillions of dollars in holdings would be devastated almost overnight.

The Washington Post is now talking openly about something that would have seemed impossibly scary and absurd a few years ago - a $1 trillion deficit for 2009.

So, how confident does all this make you feel about this economic downturn being *short?*

QUESTIONNAIRE

"Based on the twelve danger signs just presented . . . and assuming that we collective felt that there was a chance that this was going to be a very prolonged, (a minimum of five years) and extremely painful economic downturn – how would that affect our strategic thinking and the decisions that we make with respect to the direction that we pursue on a number of fronts?"

PLEASE give me your confidential, thoughtful and detailed responses to each of the following questions. We will then draft a compilation (without attribution) of all the responses received and have it available for discussion at our upcoming 'Strategy Summit.'

1. Are there any areas of discretionary spending (staff functions that have tended to 'put on weight,' nonessential projects that seemed like good ideas at the time, etc.) where you feel that we should be making budgetary cuts?

2. Are there any areas (supplier contracts that could be renegotiated, tasks that could be automated, meetings that could be held without travel, moving resources to less expensive locations, etc.) where we could be more creative and far more cost-effective in how we operate?

3. Given that in times of economic adversity 'cash is king' – are there actions that we should take to better enhance and preserve our cash flow (ensuring that all WIP is billed in a more timely manner, putting extra attention into collecting receivables, reminding clients that are slow to pay, and discontinuing representation of those clients who are not paying their bills)?

4. What can we now do (in a more proactive manner) to get closer to, add value, and enhance the relationships we have with our key clients – that we have not found sufficient time in the past to do properly?

5. Is there something we should be doing (perhaps be doing differently) about where and how we market our legal services (to reduce our reliance on a few marquee clients or a few practice areas or a few offices) and the client industries that we choose to target (some industries, like makers of hefty durable goods, are already in free-fall and may be particularly vulnerable to wide-scale bankruptcies)?

6. Given that most firms have been able to boost rates 4 to 8 percent at the beginning of every year and that such hikes will be in very bad form in the current environment, are there ways in which we might price our service, and/or methods in which we could improve our productivity to enhance the firm's profitability going forward?

7. Do we have the right mix of practice groups and geographic offices, and is it time to invest more heavily or withdraw for some of them?

8. What choices (the type of candidate we need, in the practice area that makes sense) should we be making in the laterals that we seek to recruit to our firm?

9. Are there underperformers in our firm (those who don't produce, follow the rules, irritate clients, crush morale, and drive away high performers) that we have been slow to address and that now need some timely attention?

10. How can we better recognize, reward our top performers and make their lives easier when our ability to offer the same kind of compensation increases that we have in the past, may be somewhat limited?

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For more than 25 years, **Patrick J. McKenna** (www.patrickmckenna.com) has constructed and defined competitive strategies for law firm transformation and growth. He works with the top management of leading firms to discuss, challenge, and escalate their thinking on how to effectively manage and compete. He is also one of the profession's foremost authorities on practice group leadership and the author of numerous business bestsellers including *First Among Equals: How To Manage A Group Of Professionals ((*Free Press, 2002).