

# The Financial Crisis: Causes and Possible Cures



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# Basic Background

- **Government policies primary cause of crisis**
  - **Mixed Economy**
- **Liquidity issues in capital markets have been created by deflation in residential real estate markets**
- **Other factors are significant and created “perfect storm”, however; are less fundamental**

# Residential Real Estate

**\$600 billion overinvestment in residential real estate**

- **Too many houses, too big of houses, houses in wrong place.**
- **Should have invested in technology, manufacturing capacity, agriculture, education, etc.**

# How Did Overinvestment Of This Magnitude Occur

**Only Government Can Make A Mistake Of This Magnitude Possible**

- **Federal Reserve: Government owns monetary system**
  - Unlimited federal debt / print money
  - Reduced capital requirements
  - Perception of “no” risk
    - Low savings rate
  - Significant mismanagement of monetary policy
  - Inverted yield curve
- **FDIC Insurance**
  - No market discipline
  - IndyMac as example
- **Tax policy**

# How Did Overinvestment Of This Magnitude Occur

- **Affordable Housing / Subprime: NY Times 9/30/99**
- **Freddie Mac / Fannie Mae**
  - **Leverage 1000 to 1**
  - **\$5 Trillion**
  - **Government did have to “bailout” – implied guarantee:**
    - **not true for AIG**
  - **Politics**

**Belief that housing prices never fall**

**Other important factors: to be discussed**

# Residential Real Estate Markets

**Ultimately residential real estate values are driven by the cost of reproduction, affordability and the cost to rent.**

**From peak residential real estate prices need to fall 30% to become affordable.**

**(All numbers are rough approximate and national in scope – markets vary materially)**

# Bad News

**Residential real estate values have fallen 20% (U.S.)**

**The fall has destroyed \$500 billion in capital in financial services industry**

**Financial intermediaries leveraged 10 to 1**

**– Investment banks 30 to 1**

**\$500 billion x 10 = \$5 trillion in liquidity lost**

**Some capital replaced = actual loss of liquidity “guesstimate”**

**\$2.5 trillion**

# **Bad News**

**Fear of additional decline in real estate values of \$100 billion or more**

**Destroy \$1 trillion or more in liquidity**

**No more capital for financial intermediaries because of unknown “bottom” in real estate – may go past affordability: WaMu debt holders “wiped out”**

**Housing overbuilt in other countries and foreign banks heavily invested in U.S. housing – international liquidity problem**

# **Pre-Panic Cure**

## **Foundation for Market Stabilization**

**To become affordable, residential real estate prices (cost to purchase) needs to fall an additional 10% – Approximately \$100-\$150 billion.**

**However, if prices fall \$100-\$150 billion financial institutions will leverage down (10 to 1) \$1-\$1.5 trillion – probably more because prices may fall below affordability due to capital constraints.**

# 10% Tax Credit

- **10% tax credit on residential real estate purchases**
- **Reduces cost to buyers without reducing price to sellers**
- **Available to all / also receive interest deduction**
- **Goal: to entice individuals to purchase real estate who would not otherwise invest at this time**
  - **Clear housing market**
- **Government sponsored once in a lifetime – “fire sale”**

# 10% Tax Credit

- **Only available for new houses under construction (or completed) and pre-owned homes for sale as of September 1, 2008**
- **Do not want to incent additional house construction**
- **Incent to act now**
  - **only available to June 30, 2009**
  - **limited to \$150 billion: first come / first serve**  
**(use part of \$700 billion)**
- **Must have carry forward tax feature for everyone, and must be available to high income individuals – pay taxes and have capital**

# Example:

- **House for sale \$200,000**
- **Not willing to buy at \$200,000, but would buy at \$180,000 (10% tax credit)**
- **Current home owner (Tom) wants to buy new house for sale at \$250,000 – He gets double deal – sells his house for \$200,000 and only pays \$225,000 for new house**

# Example:

- **Tom and his family win**
- **Builder does not go broke**
- **Bank gets loan repaid / can re-lend money**
- **Broker, attorney, appraiser can pay their home mortgage**
- **“Old” house rented: “cheap” investment**
- **Fred and his family move out of mobile home into “old” house**
- **Joe and his family move out of “broken down” shack where 5 families live to Fred’s mobile home**

# Example:

- **Jones' incented to purchase retirement home in Florida: cost \$225,000 instead of \$250,000:**
  - **once in a life time deal**
- **Builder in Florida does not go broke**
- **Bank gets loan repaid / relends money**
- **Realtor, attorney, appraiser can pay their mortgages**
- **Jones' not ready to retire: rent house “cheap” to Smiths': who move out of mobile home**
- **Thomas' family moves out of “broken down” shack where 5 families live to Jones' mobile home**

# 10% Tax Credit

- House prices stabilize
- Every home owner in America wins:
  - greater sense of security
  - willing to invest / spend
- Home equity lines have availability
- Capital markets can properly estimate losses / establish value for mortgage bonds
- Liquidity starts to return to markets

# 10% Tax Credit

- **Pre government leadership induced “panic”, if combined with the elimination of Fair Value Accounting, and the Federal Reserve performing its primary function of providing liquidity, would have stabilized markets.**
- **Curing “panic” will take much more. However, this is critical first step to restoring liquidity – should be done immediately.**

# **Another Factor:**

## **Why Residential Real Estate Markets Not Clear?**

- **Why have residential real estate prices not already fallen 30% and market correction passed**
- **Agriculture markets always clear**
- **Bankruptcy / foreclosure laws: dramatically slow clearing process**

# Example:

- **You make \$190,000 loan to Jerry and family to purchase \$200,000 house in Florida: House prices always appreciate**
- **Jerry becomes an alcoholic: loses job**
- **Price of Jerry's (your) house declines 20%**
- **Jerry has nothing to lose: you have \$180,000 to lose**
- **Jerry takes bankruptcy in Florida: 2 year free rent – remains alcoholic – no motivation to solve problem**
- **The hardworking honest Thompsons would be glad to rent house. Must remain in mobile home at hurricane risk**
- **Real stories: visit any mortgage collection center**
- **90 day moratorium on foreclosures will lower all real estate values**

# Fundamental Role of Financial Intermediaries (Banks)

## Liquidity Issue

- **Enable individuals to invest for longer periods than savers want to have their money invested: Pool Risk – credit and liquidity**
- **Borrow short / lend long: significant role in creating economic growth**
- **When cannot sell assets financial institutions can not meet liquidity requirements**
- **Bear Stearns: solvent but not liquid**
  - **Not happened in many years**

# Another Factor:

## How Did Residential Real Estate Markets So Significantly Impact Capital Markets

- **Subprime mortgage crisis**
- **Failure of rating agencies: S&P / Moody's / Fitch: Government sanctioned**
- **Market could not evaluate risk: no liquidity**
- **Auction Rate Municipal Bond Market**
- **Ambac, MBIC – Insurance / mortgage and municipal**
- **S&P, Moody's, Fitch rating of AMBAC, MBIC – not reliable**
- **Lack of liquidity / bonds not marketable at almost any price**
- **BB&T has plenty of money to lend**

# Another Factor: Fair Value Accounting

- **New accounting rule: mark-to-market**
- **Does not work when there is no market:**
  - **Inconsistent with law of supply and demand: must be willing buyer and willing seller**
  - **Violates “going concern” concept**
- **Major Cause of systematic liquidity problem: Public companies not purchase economically valuable assets because of accounting risk**
- **Fails to consider gains. Example: bank retail deposits**

# Fair Value Accounting

- **Asset values should be based on projected cash flows, not “fire sale” value**
- **If Fair Value Accounting applied in 1990 U.S. financial system / economy would have failed**
- **If applied to all business in U.S. as applied to financial intermediaries: 90% of U.S. businesses would be insolvent given lack of liquidity in markets**
- **SEC (government agency) makes accounting rules: i.e., laws: primary supporters of Fair Value: State Government and union pension plans**

# **Another Factor: “Pick-A-Payment” Mortgage**

- **Owe \$1,000 interest per month; only pay \$500**
  - **Each month you owe more on your house**
- **Targeted at high growth markets: CA, FL, etc**
- **Golden West (Wachovia) / WaMu / Countrywide**
  - **Only possible with FDIC Insurance**
- **Why BB&T did not offer product**
  - **Mission**
  - **“Trader Principle”**

# **Another Factor: “Originate and Sell” Model**

- **Federal Reserve / FSLIC systematically destroyed thrift industry in 1980 – 1990 period (prime rate 21%)**
- **“Originate and sell model” replaces “originate and hold”**
- **Freddie/Fannie drive many financial intermediaries out of mortgage markets due to government guarantees on debt: leverage 1000 to 1 – lower cost of capital**
  - **Encourages banks to hold riskier mortgages**
- **Freddie/Fannie make “mortgage broker” origination model viable – Brokers feed Countrywide/Washington Mutual who feed Freddie/Fannie to meet “affordable housing” goals**

# **Another Factor: Originate and Sell**

- **Perverse incentives for originations: sloppiness/fraud**
- **S&P, Moody's, Fitch (government sanctioned) make huge rating mistakes**
- **Investment bankers create financial “innovations” under belief that Federal Reserve will keep risk in financial markets low**
- **Investment bankers make irresponsible decisions based on pragmatic thinking: i.e., short term: irrational/lacks integrity/evasion/arrogance**

# Another Factor: Leverage on Leverage

- **Commercial banks leveraged 10 to 1**
- **Investment banks leveraged 30 to 1**
- **Investment banks “eat” each other: Bear Stearns?**
- **Triple Leverage**
- **CDO / SIV / CDO<sup>2</sup>**
- **Credit Default Swaps (CDS)**
  - **AIG**
    - **Violates basics of insurance: becomes “casino”**
  - **State government pension plans / public university endowments invest in hedge funds who speculate in CDS and short stocks**
  - **Why Save AIG?**
    - **Insurance subsidiaries safe**

# Misregulation: Not Deregulation

- **Regulatory cost at all time high at peak of bubble (2005-2007)**
  - **Sarbanes Oxley**
  - **Patriot Act**
- **Irrational belief in “models”**
  - **Wachovia as “Best Practices”**
  - **BASEL/European banks**
- **Huge misdirection of management energy**
- **Bank Regulators pose major risk to residential construction and development industry**
  - **Talk one game / play another: unequal incentives for regulators**

# **Why Markets Initially Perceived “Bailout” Programs Would Not Work**

- **HOPE Program creates perverse incentives with 20% “haircut” from appraised value which could drive real estate values lower: i.e., below affordable: Help few borrowers**
- **TARP #1 Program creates major issues:**
  - **How will mortgage bonds be priced**
  - **Will government foreclose on houses or not**
  - **Failure to foreclose will encourage many other homeowners not to pay mortgage: huge potential problem**
  - **If foreclose, where are resources to liquidate houses**

# **Why Markets Initially Perceived “Bailout” Programs Would Not Work**

- **Programs are totally focused on marginal borrowers – not fundamental residential housing deflation problem**
- **How many marginal borrowers are really victims?**
  - **Did not put anything down**
  - **Nothing to lose: remember Jerry**
  - **Bought bigger houses**
  - **Choose pick-a-payment: after offered fixed rate**
  - **Speculators: even if live in house**
- **What about individuals who did not make unwise investments: my son vs. my other relative**
- **More rational to reward the prudent instead of imprudent: tax credit**

# Why Markets Initially Perceived “Bailout” Programs Would Not Work

- **Moral risk is extremely important:  
Example from BB&T Mortgage Servicing**
- **There are no meaningful benefits to healthy financial institutions from HOPE and TARP #1 programs – in fact they create risk for healthy companies because they do not help residential real estate markets**

# **Market Corrections Are Not All Bad “Panics” Are All Bad**

- **World is a better place to live with Countrywide and WaMu out of business: misallocations of capital.**
- **Credit standards were far too loose at peak of bubble: standards need to be tightened.**

# **Market Corrections Are Not All Bad**

## **“Panics” Are All Bad**

- **“Panics” negatively affect even the best run financial companies and the overall economy**
- **Even best run financial institutions had to compete against risky institutions**
- **Remember: Financial institutions borrow short and lend long:**
  - **“Panic” creates liquidity risk for all**
  - **Too tight of lending standards are destructive**
  - **Self fulfilling spiral down**

# TARP #2

- **Necessary given the unnecessary government leadership created panic**
- **Will help liquidity problem: unknown is whether it will make people want to borrow**
- **Capital injection in banks**
  - **Creates lending capacity**
  - **Increases willingness of banks to lend to each other**
- **FDIC Debt Guarantee**
- **FDIC insurance**
  - **\$250,000 (TARP #1)**
  - **Unlimited non-interest deposits**
    - **Primarily helps small / weak banks**
- **FED Buys Rated Commercial Paper**

# TARP #2

- **Most banks will probably participate because it is not practical to compete against competitors who have government assistance**
  - **Regulators are encouraging participation**
- **Stock market believes benefits are primarily to weaker banks**
- **Long term effect: Moral hazard**
  - **Reward excessive risk taking?**
    - **A zebra does not change its stripes**

# What Are Possible Cures Immediate

- **Unnecessary situation: Fed Reserve mismanagement: years of warnings on Freddie/Fannie: political leadership disaster create “panic”**
- **Scrap HOPE and TARP #1 (except a few aspects)**
- **TARP #2: necessary in the unnecessary circumstances**

# What Are Possible Cures Immediate

- Create a credible program that deals with deflation in residential real estate which is cause of problems in capital markets
  - 10% tax credit
  - \$150 billion
  - Will help all homeowners (including high income individuals who have capital to fix problem)
- Nothing is as important as stabilizing residential real estate market
- Any program not focused on residential real estate will not be most effective way to solve problem

# What Are Possible Cures Immediate

- **Federal Reserve provide liquidity to financial intermediaries primarily focused on core banking systems:**
  - **Federal Reserve buyback long term Freddie/Fannie bonds to lower mortgage rates**
- **Obtain leadership in Treasury/Fed Reserve who understand “real” markets / main street – healthy banks have not been involved in discussions**
- **Inflation is very bad: deflation is far worse**

# What Are Possible Cures Long Term

- **Privatize / Liquidate Freddie/Fannie – After crisis: 2011**
  - **Political risk / affordable housing**
- **Return to originate / hold for residential mortgages:  
Do not attempt to salvage originate / sell model: Canada**
- **Federal Reserve stripped of powers: one basic goal to grow  
monetary supply at fixed rate (Milton Friedman – 3%)**
  - **Do not manage in short run**
- **Consider market based standard (gold)**
  - **Federal Government owns monetary system: unlimited  
federal debt**

# What Are Possible Cures Long Term

- **Raise capital requirements for bank (especially “start ups”)**
  - **Reduce FDIC insurance back to \$100,000**
- **Make it explicitly clear that Federal Reserve can not/will not “save” non-banks**
  - **If you buy GE’s commercial paper that is your risk**
- **Restore discipline to system**
  - **Save more**
  - **Spend less**

# Deepest Causes are Philosophical Different Than You May Think

- **Altruism**
  - Affordable Housing
  - Redistribute from productive to non-productive
  - No one has a right to their own life
- **Pragmatism**
  - Short term: What works: Subprime worked for several years
  - Irrationality
  - Lack of integrity
- **“Free Lunch” Mentality**
  - Social Security
  - Medicare
- **Lack of Personal Responsibility**
  - Death of Democracies: Tyranny of Majority

# Deepest Cure is Philosophical

- **Life, Liberty, and the Pursuit of Happiness**
  - Right to your life and your happiness
  - Personal responsibility
  - No “free” lunches
- **Rationality: Reality, Honesty, Integrity, Justice, Productivity, Pride, Independent Thinking, Self-Esteem, Teamwork**
- **Pursuit of each individual’s long term rational self-interest in the context of the “Trader Principle” – creating win/win relationships**
- **Atlas Shrugged (1957)**

# **What Happens Now? Short Term**

- **Recession is almost certain: How deep?**
- **Global Financial Crisis will likely be contained:  
Fed / International Governments will not make  
mistakes of 1930's**
- **Probably some economic recovery in 2010**

# What Happens In The Long Term

- **Depends on us**
- **Continuation of Altruism / Free Lunch mentality will ultimately result in economic disaster: forces in motion to make disaster possible: Social Security deficit, Medicare deficits, government operating deficits, irrational foreign policy: Demographics: failed K-12 education system**
- **A return to individual rights, limited government, free markets which lead to personal responsibility and self-discipline can restore long term positive economic trends**
  - **We need less regulation, not more**
  - **Every time government makes big mistake the answer is more government**
- **American Sense of Life: Good News!**