



# Turmoil in the Markets

October 6, 2008

If you try to fail,  
and succeed,

which have you done?



# Who's To Blame?

## (Congress)

- 1977: Pres. Carter urges Congress to pass bill to encourage lower-income households to purchase a house = looser lending standards
- 1995: Pres. Clinton puts pressure on banks to make mortgage loans to low-income borrowers. Banks are threatened with legal/regulatory action if they don't
- 2000+: Warnings from some in Congress about a "house of cards". Reform bills die in committee. White House did not follow through, and praised growth in home ownership.
- Congress looked the other way, winked, and accepted huge contributions from the real estate industry, Wall Street, and from Fanny Mae and Freddy Mac
- As with the Savings & Loan crisis of the 1990s, the mortgage business was **"designed to fail"** – mandated/enabled and regulated by Congress (See Slide #2)

• **Result? A "Perfect Storm"!**

# Who's To Blame? (Builders)

- Builders constructed homes on speculation
- Then facilitated “no question” loans to buyers

# Who's To Blame? (Real Estate Agents)

- Real estate agents urged buyers to purchase more expensive homes based on cheap borrowing costs = Greed > Fear
- Then facilitated loans through captive subsidiaries.
- “Flip This House” on TV rarely showed losses

# Who's To Blame? (Lenders)

- Lenders (banks and mortgage companies) innovated “teaser” loans, ARMs, 100% financing, “Alt-A” (Option Rate) loans, and no income check documentation
- Collect loan generation fees, sell the loan, repeat
- Don't forget the Federal Reserve – Alan Greenspan was a strong proponent of easy credit.

# Who's To Blame?

## (Buyers)

- Buyers believed house prices would continue to rise (forever?).
- “Flip This House” became popular on TV – Real Estate seminars proliferated (“No money down”)
- Buyers looked at monthly payments rather than valuation – borrowed to the max, and beyond
- Used home equity to finance other purchases and pay down credit cards
- Increased fuel and food prices squeezed budgets
- ARMs adjusted up = 30% increase? Ouch!!
- Zero equity (or negative equity!) made it “easy” to walk away – leave keys in the door

# Result (Home Builders)

- Housing stock became over built – some areas of rapid price appreciation saw unsold inventory exceed 3-years of sales (AZ,CA,FL)
- Many homes built/purchased on spec were never occupied; they were bought to flip (i.e. a short-term investment)
- All this was financed with heavy leverage
- A cyclical decline, or just slower price growth would cause the “game” to end = crash

# Result

## (Mortgage & Investment Bankers)

- Mortgage bankers and investment bankers packaged loans sold by lenders, thereby returning funds to lenders to loan out again – and generate fees
- Rating agencies (S&P and Moodys) relaxed rating standards for loan packages – and accepted huge fees
- Mortgage investors borrowed heavily to purchase loan packages – often using commercial paper

# Results

## (Financial Institutions)

Institutions violated several “rules” of finance

- Don’t finance long-term investments with short-term money (i.e. Matching Maturities)
- Leverage is wonderful – but too much is dangerous
- “What Goes Up, Comes Down” (Isaac Newton)
- Cash is King – when you’re out of cash, you’re out of business

# Results

## (U.S. Banks)

- Banks forced to write down non-performing loans and investments (e.g. Fanny Mae preferred stock)
- Asset dilution is written off against equity
- The “equity multiplier” works in reverse when equity declines – loan creation ability shrinks dramatically
- Banks tightened credit, cut back on lending – even for “good” credit = can’t afford more loss

# Results (Investors)

- Loss of confidence
- Less willing to buy commercial paper
- Investors unable to get loans – so sold assets further depressing prices
- Money managers sold stocks to meet redemption demands
- Expiration of “uptick” rule and widespread (illegal) “naked” short selling pushed markets down more
- “Flight to quality” – sell stocks > buy Treasuries >0.5% short rates

# Results (Business)

- Businesses unable to get loans – so they cut operations and employment to conserve cash
- This removed more cash from the financial system

“The market can stay irrational  
longer  
than you can stay liquid.”

(John Maynard Keynes)

# How Did This Happen?

**Answer:** The willing and deliberate suspension of disbelief by groups who either knew better, or should have:

- Congress & Leaders – both parties
- Builders
- Real Estate Agents
- Lenders/Investors – Banks and Wall Street
- Home Buyers
- Voters – both parties

*“All that is necessary for the triumph of evil is that good men do nothing.”* (Attributed to Edmund Burke, Irish Philosopher & Statesman, 1770 )

# Bailout? – Rescue? – Stimulus?

## All Of The Above!

### Who “Wins”?

- **Wall Street?** Partially: Some are relieved of toxic loans, but many others lost everything (Lehman Bros.) or a lot (Bear Stearns, Merrill Lynch).
- **Banks?** Partially: Many will return from the brink of shortfalls in regulatory capital. It remains to be seen how quickly they will resume lending, and under what terms. Too big to fail?
- **Big Business?** Hopefully they will retain/regain some short-term borrowing capability to tide them over while they continue to deal with high fuel and commodity prices.
- **Main Street?** Many will fail unless liquidity is quickly restored. Most businesses rely on short-term loans that have effectively dried up as their lenders retreat from lending even to “good” credits.
- **U.S. Treasury?** Quite possibly they could make a profit selling mortgages they buy at pennies on the dollar. But, how long could that take?
- **Congress?** The BIG WINNER – “investigations” will point in every direction except the mirror. Congress will declare “victory” but not accept any blame. Real risk of new regulations that hinder operation of free markets

**“The early bird gets the worm”.**

**But the second mouse  
gets the cheese!**

(Warren Buffet?)

I know Buffet didn't say this – but he could have. (Note Buffet's recent investments in Goldman Sachs and General Electric)

# What (Should) We Have Learned?

- Leverage operates in both directions!
- Lending someone else's money to a borrower who has little chance to repay – is dumb!
- Real risks should be evaluated with real criteria – not utopian wishful thinking!
- Don't spend what you don't have! Think ahead!
- Greed often trumps Fear!
- Congress is reasonably good at fixing problems, but terrible at preventing them.
- Often, Congress IS the problem!
- The Bailout/Rescue/Stimulus package is Step #1
- Many more steps, and many more \$\$, are necessary to restore confidence in world financial markets.

# What We Should Have Learned (But Probably Didn't)

- Somebody forgot (or chose not) to watch the store
- “Deregulation” wasn’t the problem. There were plenty of “new and improved” regulations from Congress that facilitated the excesses in the market
- No entity should be allowed to become “too big to fail”
- If there is no penalty for failure, excessive and foolish risks are being rewarded – and will persist
- Don’t put the fox in charge of the hen house
- Congress might benefit from more economists - and fewer lawyers

# Philosophy Lesson

Some Days You're The Pigeon

And

Some Days You're The Statue!

# Which Are You Today?