

## Demystifying the Nation's Financial Mess

How did we get in the complicated financial mess (**in one page**)?

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### Key Factors (Several simultaneously occurring)

<b>Factor</b>	<b>Who to Blame?</b>
1. Housing prices were driven by hype, greed and false expectations, especially in CA, FL, NV, AZ. 2000-2005 in most markets. Short-term thinking by GM and layoffs by Pfizer hurt Michigan and N. Ohio.	Homebuyers, GM executives
2. Mortgage lenders encouraged risky loans by choosing appraisers who verified contract prices 95% of the time. Mortgage brokers who worked merely for fees were among the worst, sometimes encouraging lying on loans and initiating predator loans that were not affordable. CA homebuyers used a greater proportion of interest-only and ARMs, which they would not be able to afford when teaser rates expired and resets hit.	Mortgage lenders and brokers, appraisers, home buyers.
3. Implementation of Basel 2 risk-based pricing agreement and reserve requirements was delayed at the request of lenders and accommodated by the Federal Reserve. Risk-based reserves should have taken effect 2006-2007 and would have required more capital reserves for loans in housing markets poised for bubble trouble; thus, it would have increased the rates on loans in most CA markets. Some of the mortgage mess could have been avoided.	Federal Reserve Bank, which censored warning research by James Follain, Ph.D. and others
4. The subprime market exploded allowing homeowners previously unable to qualify for homeownership to buy homes during 2000-2006. Predatory lending accelerated.	Lenders like New Century, Countrywide, etc.
5. Fraud detection tools ignored by most lenders. Appraiser rating systems were available as well as fraud detection systems. Only FICO scores were considered and collateral risk and fraud was ignored by most lenders. These loans were packaged into securities and sold in tranches based on security ratings.	Appraisers, lenders who planned to sell off the loans
6. Rating agencies rated mortgage pools using internal models based on a very limited history of subprime mortgage performance, thus ignoring the fundamental collateral risk warnings and indicating great safety to investors. These same rating agencies also ignored predatory lending practices.	Moody's, S&P, Fitch, etc. ignored market warnings by many economists.
7. Collateralized Debt Obligations (CDO) made the problem worse by combining low-rated paper and somehow creating higher-rated paper. These were sold globally.	Moody's, S&P, Fitch, etc.
8. Wall Street investment banks and brokers that created the RMBS (Residential Mortgage Backed Securities) market and sold these securities, which they knew were risky but generated high fees. Wall Street's compensation system of paying huge bonuses for current deals fosters a culture of selling anything without much concern for the longer-term performance. Wall Street pocketed their fees/commissions up-front and let someone else clean up the ensuing mess.	Lehman Brothers, Merrill Lynch, Morgan Stanley, Bear Sterns, etc.
9. Investors of the RMBS who took everyone's word (ratings agencies, Wall Street investment bankers, etc.) about the quality of what they were buying without doing their own analysis of the riskiness of the securities.	AIG and investors around the world
10. Easier mortgage qualification and low interest rates helped sustain home price increases. Appraisals based on unsustainable prices justified loans while LTVs increased. Uneducated homebuyers signed teaser and adjustable rate loans.	Homebuyers, Federal Reserve, predatory lenders, rating agencies
11. Fannie Mae and Freddie Mac (GSEs), which prior to 2003 claimed they would never knowingly buy subprime mortgages, accelerated purchase of subprime loans without a parallel increase in capital reserves, thus increasing dramatically the risks borne while providing highly leveraged and temporarily profitable returns to shareholders.	Fannie Mae, Freddie Mac, OFHEO, Fed, Congress for allowing GSEs to be exempt from normal audit standards
12. Financial derivatives (CDOs) and other instruments (credit default swaps) were sold (up to \$60 trillion in volume) within an unregulated market by investment banks with very little capital reserves. Long and short trading with margins can allow 33 to 1 leverage exacerbating the volatility of prices in the securities market using over-rated instruments that few investors really understand.	Lack of oversight by SEC, Congress, Senate, White House, naiveté by elected officials, Fed
13. Mortgage portfolios became riskier as home prices (collateral) started to deteriorate, but there was <b>no marking to market</b> of the underlying mortgages or securities.	All of the above
14. Home market statistics from CAR, DataQuick, NAR, S&P Case Shiller misused by the media and sensationalized, leading to paralysis in many housing markets and making the problem worse.	Media

## What can and can't the bailout accomplish?

- ✓ The bailout or TARP (Troubled Asset Relief Program) has several goals. The Treasury is authorized to **purchase troubled assets at “fair market value.”** The problem is quickly determining fair market value. For mortgage purchases or mortgage-backed securities, this requires an understanding of home values and mortgage values under distressed conditions. Research suggests typical discounts of 22% on home values when **under foreclosure, but the discounts have been much greater in the last year—up to 40% and 50% in many cases,** especially when self-vandalization occurs (stolen appliances, fixtures, etc.) We also note the problem of contagion effects. That is, neighborhood home values are lower when foreclosures are concentrated. Models do exist to do such work quickly, but the implementation may be a challenge. Where possible, the Treasury should let the market bid for such assets right away.
- ✓ When the government bails out a private firm, **all shareholder values should be forfeited.** That is, the government should be able to become the owner and re-privatize the company and sell it when stability returns. Such policies will be determined by managers of the bailout process.
- ✓ **TARP could turn into a bailout for counties, cities and even states** in terms of a lender or guarantor of last resort. Falling property taxes and sales taxes will require significant operating expense cuts.
- ✓ Because the purchase of troubled assets at fair market value may leave financial firms severely under-capitalized, the Treasury's authority seems to **allow purchasing**—at fair market value—**new securities** issued by financial institutions in need of additional capital. Banks in need of liquidity that are well managed appear to be recipients of such capital infusion. This approach is much more effective than buying bad mortgage loans.
- ✓ Financial firms should be required or induced to raise capital through right offerings to their existing shareholders as a way to raise funds.
- ✓ **TARP will result in a new and large property management** firm under the direction of the Fed. This agency will become a landlord and work out specialist subcontracting at a break-neck speed. The effectiveness of this operation depends on who is hired to staff it.
- ✓ **TARP does not bail out homeowners by forcing forbearance.** It does encourage loan restructuring and modification as a way to minimize losses but the very presence of TARP may make lenders less amenable to such write-offs choosing rather to turn to the Treasury for selling troubled loans. TARP is not a panacea of solutions for homeowners who have defaulted. If it is highly successful, when combined with the takeover of Fannie Mae and Freddie Mac, it will enable the capital markets to issue mortgage-backed securities again and allow credit-worthy borrowers to continue to buy homes. This, in turn, will help add some notion of liquidity to the markets, but it will take a while for spreads to return to normal and rating agencies to become trusted once again.
- ✓ While TARP is 451 pages in length, **only 98 pages deal with the bail out.** The Senate's pet projects fill the balance and deal with energy, deposit insurance, executive compensation and several tax rules that could make the budget deficit even worse. This bailout will in the short run cost about \$7,000 per household and bring our collective debt to nearly \$80,000 per household beyond existing mortgage loans, car loans and credit car loans. This is certainly an added loan that rational lenders would not approve. **It also may not be enough.**

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