

# **The Financial Crisis: Causes and Possible Cures**



*Best Bank In Town  
Since 1872*

# Basic Background

- **Government policies are the primary cause of crisis**
  - **Mixed Economy**
    - **Financial industry more government than private**
- **Deflation in residential real estate led to liquidity issues in capital markets – laying the foundation for a significant recession**
- **Other factors are important and created “perfect storm”, however, are less fundamental**

# Residential Real Estate

**\$800+ 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.**
- **Should have saved more!**

# How Did Overinvestment of this Scale Occur

- Only government can make a mistake of this magnitude possible
- Primary Sources of Problems
  - Federal Reserve
  - FDIC
  - Housing Policy
    - Freddie Mac / Fannie Mae
  - SEC
- Government policy makers (Treasury, Federal Reserve, President, Congress) turned a natural market correction into a panic
- Most government action since “crisis” began will reduce standard of living in the long run

# **Government Policy As Causation Federal Reserve (Fundamental Cause)**

- **Government owns monetary system**
  - **Unlimited federal debt / print money / inflation**
  - **Reduced capital requirements for banks**
  - **Perception of “no” risk**
    - **Low savings rate**
  - **Significant mismanagement of monetary policy**
  - **Inverted yield curve**
- **Problems with Federal Reserve are systems design: many outstanding people at Fed – Fatal Conceit (Hayek)**

# **Government Policy As Causation**

## **FDIC Insurance**

- **Lack of market discipline**
- **Start-up banks: Atlanta**
- **Indy Mac, WaMu, Countrywide: as examples**

# Government Policy As Causation

## Housing Policy

- Increase home ownership above natural market rate
- Tax policy
- Affordable Housing / Subprime: NY Times 9/30/99
- Freddie Mac / Fannie Mae: Government sponsored enterprises
  - Would not exist in free market
  - Leverage 1000 to 1
  - \$5 Trillion
  - Government did have to “bailout” – implied guarantee:
  - Politics
- Freddie / Fannie primary current cause of housing/financial problems
- Belief that housing prices never fall: based on government policies

# **How Did Residential Real Estate Markets Create Financial Crisis**

**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

**Initially residential real estate values fell 20% (U.S.)**

**The fall 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”  
\$3.0 trillion**

# Bad News

- **Fear of additional decline in real estate values of \$100 billion or more**
- **Would destroy \$1 trillion or more in liquidity**
- **Limited capital for financial intermediaries because of unknown “bottom” in real estate – may go past affordability**

# Bad News

**Treasury, Federal Reserve, FDIC destroy capital markets for banks when they completely “wipe out” WaMu debt holders. These federal agencies created “need” for financial institutions “bail out” program**

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

# Another Failure of Government Policy: 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**

# **FDIC Insurance Makes “Pick-A-Payment” Mortgages Possible**

- **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”**

# **How Government Policy Created “Originate and Sell” Model**

- **Federal Reserve / FSLIC systematically destroyed thrift industry**
- **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 (Golden West) 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 to keep support in congress**
- **“Originate and sell model” replaces “originate and hold”**

# 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 “greedy”/dumb-pragmatic thinking: i.e., short term: irrational/lacks integrity/evasion/arrogance**

# 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 have tightened lending standards!**
  - **Talk one game / play another: unequal incentives for regulators**

# **Market Corrections Are Not 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 – Excessive leverage**
- **Saving rate needs to be increased**
- **Overinvestment in housing needs to be corrected: less capital to housing: more to productive investment**
- **We needed a correction: natural market process: creative destruction**
- **We did not need a panic: never would have had excesses and misallocations of this magnitude without government policy**
  - **We would have experienced minor corrections all along**

# **“Panics” Are All Bad**

- **Unnecessary and inappropriate actions of Federal Reserve, Treasury, President and Congress have created “panic”**
  - **\$700 billion: scary amount**
  - **Inconsistency (Citi vs. Wachovia / Goldman vs. Lehman)**
  - **Unpredictability**
- **“Panics” negatively affect even the best run financial companies and the overall economy: creates liquidity risk for all**
- **Even best run financial institutions had to compete against risky institutions**
- **Too tight of lending standards are destructive**
- **Self fulfilling spiral down**
- **Price instability (both inflation and deflation) is destructive: causes economic miscalculation**

# TARP #2

- **Capital injection in banks: investment must be repaid with interest**
  - 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 (helps small / weak banks)
- **FED Buys Rated Commercial Paper: “Saves” GE**
- **Did help liquidity problem: unknown is whether it will make people want to borrow / delays natural correction process**

# Effect of Government Financial “Rescue” Plan (TARP)

- All large banks have chosen to participate in TARP #2 because:
  - Intense regulatory “encouragement”
  - Failure to participate would be a major competitive disadvantage
- While positioned as providing capital to encourage healthy banks to lend, a significant purpose of TARP is to save weak financial institutions and, thereby, theoretically reduce system risk
- Long term effect: huge moral hazard
  - Reward excessive risk taking
    - A zebra does not change its stripes
    - Citigroup saved 3 times: each time bigger and worse

# **Effect of Government Financial “Rescue” Plan (TARP)**

- **Oligopoly created in financial industry: not by market forces, but by extremely arbitrary government actions (Lehman vs. Goldman)**
  - **4 financial institutions “too big to fail” (maybe 9: why 9 first TARP)**
    - **Tremendous competitive advantage in funding long-term**
    - **Not selected by markets (Citigroup)**
  - **If “too big to fail” should be broken-up: anti-trust policy of Fed completely irrational**

# **Effect of Government Financial “Rescue” Plan (TARP)**

- **Healthy financial institutions (BB&T) hurt by “bailout”**
  - **End of flight to quality**
  - **Continued irrational competition**
  - **Cost of FDIC insurance**
    - **Impractical not to participate: nature of government programs**
  - **Lost opportunities to make acquisitions**
  - **Message to take more risk in future?**
  - **Competing with “too big to fail” / government created oligopolies**

# What Are Possible Cures Short Term

- Federal Reserve provides liquidity to core financial intermediaries
- Let market correct: Do not rescue any more non-banks
  - Why save GMAC – irrational auto lender
- Cut government spending
  - Do not waste resources on non-essential government programs (pork barrel)
- Cut business / corporate income tax rates: U.S. not globally competitive
- Cut individual tax rates: including high income individuals
- Do not introduce any new programs: Markets can not handle ambiguity
- Restore “cash based” accounting system

# What Are Possible Cures Long Term

- **Price instability (deflation and inflation) is destructive: Causes economic miscalculation: Risk of inflation after correction is significant: Riskiest asset long term treasuries?**
- **Most fundamental issue is the attack on capitalism / free markets**
  - **We do not have a free market in U.S.: mixed economy**
  - **Financial system is primarily government owned: Federal Reserve**
  - **By far primary causes of current financial crisis is government policy, not market failure: Federal Reserve, FDIC, Housing Policy, Freddie / Fannie, SEC, HUD**
- **Attack on “wealthy” is an attack on the productive – productive will go “on strike” in many different ways**

# 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**
  - Reintermediate to banking system
  - Do not “save” irrational competitors: mutual money funds
- **Consider market based monetary system (gold)**
  - Federal Government owns monetary system: unlimited federal debt
- **Federal Reserve stripped of powers: one basic goal to grow  
monetary supply at fixed rate (Milton Friedman – 3%)**
  - Do not manage in short run

# What Are Possible Cures Long Term

- If do not privatize banking system then systematically and materially raise capital requirements for banks (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
- Eliminate 90% of government regulations

# **What Are Possible Cures Long Term**

- **Stop subsidies to housing (tax policy)**
- **Materially reduce all government spending as % of GDP**
- **Encourage productive investment – low/neutral tax rates: tax consumption, not savings – increase productivity**
- **Free trade: Essential for economic growth**
- **Carefully and systematically privatize Medicare and Social Security**
- **Significantly cut cost of defense: By defending U.S.**
- **Encourage immigration of the productive and hardworking**
- **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: Negative amortization mortgages worked for a number of 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
- **Demands and rewards rationality / self-discipline**
- **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

- **We are in a serious recession: how deep and how long?**
  - **Real economic issues**
  - **Lack of confidence**
- **Global Financial Crisis will probably be contained: Fed / International Governments are not likely to make mistakes of 1930's**
- **Most likely: modest economic recovery in fall 2009 – followed by period of slow real growth – growth rate below economic potential – recent government “incentive” programs reduce long term productivity – stagflation?**

# 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!**
- **Principled individuals / principled leadership: Own the Moral High Ground**



**BB&T**