<u>The Financial Crisis</u>

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A. Why did it happen. First, what is the "it?" Collapse of share prices of banks, bankruptcies of major financial institutions including GSEs, freezing/paralysis of credit markets for consumers and corporations, major mortgage defaults, weak corporate prospects, collapse of stock market, loss of jobs, drop-off of consumption.

What were the causes?

1. Tremendous leverage, i.e. borrowing to finance purchase of MBS and other derivative products with little capital commitment.
2. Issuance of extremely complex, illiquid securitized instruments which were difficult to value and therefore price. Also not transparent what is inside them since they were packages of diverse credits.
3. Securitization – mortgages, car loans, credit cards. Packaged for sale.
4. Highly aggressive, if not unrealistically low valuations by accounting firms who were out to protect themselves, particularly if there was no public market on securitized packages.
5. Failure of senior management to understand risks. An asymmetrical compensation plan. Also, poor risk management systems of ultimate holders, not just banks.
6. Fall in home prices – no incentive not to default, since defaults in U.S. are generally without recourse.
7. Pressure from Congress on Fannie Mae and Freddie to purchase sub prime loans and on banks to lend, irrespective of prudential standards. But banks and others did not care because securitization permitted the initiating institution to "securitize" and then sell off the package to others.
8. Reluctance of Fed for 20 years to constrain derivative market for fear that the constraint on derivatives and leverage would remove the necessity to use government paper as collateral for those instruments; thereby making it difficult to finance the U.S. deficit.
9. Total failure of regulatory agencies and Congress to understand the details of the operations of derivative markets and how leverage really occurs despite numerous warnings.
10. Short selling, program and computerized trading, structured finance.
11. Run on banks to take out deposits.

Domino effect. Chaos theory.

B. Why government's $700 billion package is not a bailout of "Wall Street"

1. Who has really been hurt. Shares of banks down by 60 - 80%

   Bear Stearns, Merrill, Lehman, AIG, Wachovia, Washington Mutual, Freddie Mac, Fannie Mae, badly hurt if not bankrupt. That is not a bailout. And who is Washington Mutual – a bank formed from other banks in California, South Carolina, Texas, Illinois, Utah, Oregon, Rhode Island. That is Main Street.
2. Who are current holders of MBS
   - Corporate pension funds – all over country
   - State and local retirement systems – all over country
   - Regional banks
   - Banks who ended up buying packages from other banks who lent; they are the last holders – not the first makers of loans
   - holders of mutual funds and 401k's - everyone
3. The government, in any event, will recoup and probably profit because the cash flow is huge from people who are paying their mortgages and credit cards. First the government will get the interest on most of the packaged securities; second the principal will be paid down. The government will pay something between the price on the books and the expected cash flow. Of course, the higher they pay, the less the profit; the lower they pay, the greater potential gain. I assume, however, they will not use most of the $700 billion by buying these packages of car or credit cards or mortgage loans. They should use some kind of credit enhancement or guarantees – all of which will help liquefy the assets and free up cash so banks can lend again and institutions can liquefy their portfolios. It will also serve to re-price the securities on a higher mark. I suggest government should require the holders to take, say 5 to 10% of the hit or default. The government then insures the balance – 90%.
4. <u>If</u> the government buys stock in a bank, thereby injecting capital, it will insist on a substantial return – either preferred stock or interest on debt.

C. What should be done to lessen the risk for yet another collapse. Long-term.

1. A significant study by the SEC, under oath, under subpoena, on derivatives, leverage, how institutions finance themselves, how transactions are recorded, how "risk books" are maintained, by whom. The study should include all financial intermediaries, including hedge funds, the operation of the credit default swap market, how it is financed, what collateral is used and with what constraints, how transactions are recorded, how net capital rules are applied to derivatives. The study must include an examination of structured finance, computer trading, ad hoc derivative transactions since this kind of trading has a huge negative effect on the market. It should report to Congress with recommendations by the Commission or Fed indicating agreement or disagreement with recommendations. It should be done privately with the

purpose of finding out how financing and leverage is done, by whom, with respect to all products.

Congress had many warnings: Enron, Merrill Lynch, Long Term Credit, Daiwa, Sumitomo, Orange County, Barings. All derived from the same set of circumstances: leverage, illiquidity, derivatives, lack of transparency of the instrument. This crisis is no different. Same causes, same instruments – only bigger and, therefore, causing significant collateral effects.

As early as 1986, I wrote:

> "We, generally, do not mark to market. Many of the products are unmarkable. We do some transactions explicitly because our mistakes can be hidden, because accounting conventions do not record them, either because they are ad hoc or there is no market, or worse, they are off balance sheet. There is, typically, little reality testing. . . . And when losses can be ignored, greater risks are taken. I cannot take the time here to describe the latest FASB proposed draft on derivative accounting—they aren't bad; they are a beginning, but they are deficient—because they will not, yet, put you under the pressure involuntarily of admitting to failure, risk and error."

In 1994, I testified before the House Committee on Banking, Finance and Urban Affairs as follows:

> "A lot has already been written and reported about derivatives: a minority staff report from this committee, Congressional hearings, a GAO study, a Group of Thirty report and commentaries by virtually every accounting, banking and securities association. There have been press reports of losses by dealers and corporations, lawsuits, investigations and attention by every relevant regulatory agency. For purposes here, let me try to focus on why the subject matter has and will likely cause a great deal of continuing stress. I believe it is a peculiar combination of five unique and potentially dangerous circumstances.
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> First derivatives can be used to leverage risk – interest rate, currency rate, share prices – without putting up a lot of money. That simply means that during a period of volatility, losses or gains are magnified manyfold. And often the leverage is asymmetrical; that is, the potential gains are limited, while the losses may be multiples of the maximum gain.
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> Second, current accounting conventions mask error, risk and mistake. They are not designed as risk management tools. They have tax consequences, which may be one of the reasons why it has been so difficult to develop a comprehensive set of conventions which also can be used for risk management purposes.
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> . . . . Fourth, many products, particularly over-the-counter derivatives and aspects of the mortgaged-backed market are idiosyncratic,

> ad hoc, unpublicized, illiquid. That means they are difficult, if not impossible, to price or value. It means that if held as collateral, there may be no buyers in the event of a forced sale, or the spreads between buyers and sellers may be so wide that even hedges are ineffective."

Again, in 1998, I testified:

> "The truth is there is very little expertise within the federal regulatory supervisory agencies as to precisely how the financing and leveraging is actually done in practice. That must be determined by a dedicated group with full access to the most sophisticated and active players in the market."

In early 2000, I spoke to the SEC at that time to say with respect to these kinds of upheavals, ..."And they will occur again, particularly if we continue to avoid confronting the fundamental issues of leverage, off-balance sheet transactions and the deficiencies of the accounting for such transactions."

Nothing was done.

D. What steps might be taken now to alleviate some of the stresses

1. Guarantee a floor price of various MBS securities and other securitized packages i.e. after the first – say – five or ten percent loss. After that, the government would guarantee payment.
2. Massive infrastructure projects and "Manhattan Project" centers (e.g. energy, material science, information technology) to provide jobs across SES spectrum.
3. Guarantee all deposits in banks and all inter-bank borrowings.
4. Encourage banks to change terms of mortgages from LIBOR linked to T-bill linked with government paying difference.
5. Take steps to drive down LIBOR which is the rate typically used to reset mortgages. See number four above.
6. Neither Congress, the Fed, nor the SEC should talk about "regulation" unless they have specific measures concerning specific market practices they believe should be constrained. I do not believe that such information is currently available. The trader or quant has it. Even the CEO does not.
7. Unfortunately, the huge drop in the market has destroyed wealth. Therefore, no confidence. Therefore, massive drop in consumption. Therefore, unprofitability, loss of jobs. Therefore, stock market must first improve. What to do. 1) Restrict

program trading, computer trading, short selling. 2) Create incentives. (Tax rebates?) for buying homes now. The overarching economic problem is not defaults on mortgages; it is glut of homes and low prices. Therefore, we must get homes off market to raise prices and have builders start again. 3) Substantial federal tax benefits for "foreign" companies to bring their factories here – just like the States do.

In short, the key is to break the cycle of the downward pressure on markets and the drying up of credit. Stimulus packages to consumers too small to do that. Must have massive interventions in housing markets, restrictions on certain operations in securities markets, substantial use by government of guarantees for securitized instruments <u>after</u> the first hits are taken by holders, which, in turn, will cause accounting firms to re-price assets at higher prices and will therefore make them more liquid.

In the long run, infrastructure projects for jobs, taking health and part of retirement burden off the corporate sector, and most important an under oath study by lawyers on how the market works will be indispensable to fine-tune government intervention in response to future adverse events. Right now, government does not have the information to know <u>what</u> to regulate. It is way behind the curve.