

# Crisis in the Making by Steve Feilmeier

**B**ack in January, when our chairman and CEO, Charles Koch, was sharing his thoughts about what to expect in 2008, he warned us that “we could be facing the greatest loss of liberty and prosperity since the 1930s.”

If anyone doubted the wisdom of his words then, there should be little room for doubt now.

The upheaval in global financial markets has reached a point where all of us are going to be affected in one way or another.

## Tough questions

Many Koch company employees have raised questions and concerns about the growing credit crisis, federal takeovers of Fannie Mae, Freddie Mac, AIG and the \$700 billion bailout bill.

Did the markets fail? Is the financial system really distressed? Is the U.S. government doing the right thing? What are the short-term and long-term implications of these actions? Should we support the U.S. government’s actions or not? Is our company at risk?

In an effort to answer those questions, here is a summary of our point of view on all this.

## Root cause

Almost all of these problems (and much of the current chaos) are, at their root, the result of political failure.

The U.S. government attempted to stimulate more home ownership than the market would have created on its own. It encouraged the over-development of homes, particularly homes for first-time buyers financed with sub-prime mortgages.

Today’s crisis was caused by government pressure to erode lending standards, coupled with a lowering of the cost of funds to such a low level that lenders (and borrowers) were encouraged to build, even when many borrowers could not afford the monthly payment.

To make matters worse, these subsidies caused other borrowers to begin building with the intent to resell. They believed home values would only go up, allowing them to make a quick profit.

This caused housing prices to rise to unsustainable levels. When the market became glutted with much more construction than it needed (or that homeowners could afford), the

result was poor quality mortgages and excess homes throughout the country.

The U.S. government kept this false economy moving for a number of years through its indirect support and regulation of Fannie Mae and Freddie Mac, which purchased many of those “toxic” mortgages.

Ironically, many of the politicians who now claim that the markets have failed are the very same politicians who pressured for unsustainable lending practices a decade ago.

## The cost

U.S. taxpayers are now on the hook for at least \$200 billion which may or may not be recoverable in the future, and the dominoes are still falling.

Add in the \$150 billion economic stimulus package that ended this summer, the \$700 billion bailout (plus another \$150 in earmarks), and the cost of this failure easily exceeds one trillion dollars! That’s close to 7 percent of the U.S. economy.

Of course, the real cost of this most recent failure is that billions of dollars of capital were funneled into unsustainable housing projects instead of more productive assets.

## Chain reactions

As investors grew cautious of the deterioration in asset quality, three large financial institutions, Bear Stearns, Lehman Brothers and AIG, failed. Three others, Merrill Lynch, Washington Mutual and Wachovia, are being merged out of existence with other more solvent institutions.

These failures have caused fear and panic in the U.S. financial system. Capital has literally stopped flowing between savers and borrowers, and even between banks.

Credit is largely based on trust, and this trust has been severely compromised. Without equity and debt capital flowing to entrepreneurs and credit-worthy companies or consumers, any economy can slow dramatically.

We have watched the U.S.



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financial markets closely for several months. Without hesitation, we can confirm that the system really has seized up. Reports of this are not exaggerated, and are not limited to the U.S. World financial markets are also in a crisis.

Given these dire circumstances, the U.S. government is stepping in to support the system in hopes that capital will start flowing again, giving entrepreneurs the capital to invest and allowing loans to be made to support them.

### Consequences

A market economy functions best when governments do not attempt to influence outcomes with a political agenda. It is regrettable that our government is stepping in again to do just that.

These bailouts, buyouts and “supports” are poor policy that will likely cause far more long-term harm than good. Why? Because each government intervention tends to lead to new problems, prompting calls for even more government intervention.

Very soon, U.S. citizens will be faced with higher taxes to pay for bailouts, even more regulation and a weaker currency. The value of the U.S. dollar will be driven down by ever-increasing debt.

Interest rates (for entities other than the federal government) will rise, too, making it all the more difficult to be competitive in a world economy.

In the short run, government intervention might help restart these markets, but whether it will or not simply isn't clear because we have rarely faced market disruptions this severe.

In the long run, however, these steps are likely to cost us far more than any benefits we might gain in the short run.

### Learning the hard way

If we learn anything from crises such as this, it should be that government intervention – no matter how well-intended – tends to cause more harm than good.

This crisis also underscores the importance of personal responsibility, including living within our means.

What we are witnessing is not a failure of markets, but a failure of certain individuals, corporations and our own government. Many of our core principles – especially integrity and humility – have been alarmingly absent.

We do not support government interference in the market; however, the fact that our monetary system is a government system is undeniable. Thus, the government determines the health of the financial system.

Consequently, some form of action to restore confidence in financial markets is necessary, but only so long as the government does not continue overreaching, attaching political and policy agendas to its actions, and picking the winners and losers.

The bailout package that was approved by the U.S. Congress and signed by the President violated all of these tenets.

### What to do?

There are at least three things the U.S. government can do to improve this situation.

The first is to put a stop to the creation of new government institutions and programs intended to “solve” the problem. As mentioned earlier, such actions will probably create even more problems.

Instead, we should be systematically eliminating the programs and perverse incentives that created this crisis.

Second, the government should put an immediate halt to its spending spree. Here in the U.S., we are already facing \$79 trillion in unfunded liabilities. These are promises made by the government that we don't have the money to pay for.

Any nation that allows its government to incessantly overspend is headed for bankruptcy. This is also true for individuals. There are always dire consequences when we



overload ourselves with debt.

Third, the Federal Reserve needs to re-evaluate its role. Providing a reasonable amount of liquidity in the markets is a legitimate role for the Fed. Subsidizing people who've made bad decisions is not.

In short, what we need is a return to sound economic principles.

### The good news

The question of whether or not Koch Industries is at risk is much easier to answer.

Because we interact with financial markets in so many different ways, there is no question that Koch companies are affected by this financial crisis.

The good news is that neither KII nor its affiliates have made major investments in the types of assets that got so many financial institutions in trouble. What's more, we see the potential for growth opportunities as a result of these tough times.

We are confident in our ability to continue growing and investing in our businesses. Our goal is unchanged: the creation of real, long-term value by the economic, not political, means. ■

This article is based on a recent e-mail sent by Steve Feilmeier to all Koch company employees. We encourage you to share it with your friends and family.

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