The Financial Crisis:
Causes and Possible Cures

BB&T

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 <u>saved</u> 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**

Fundamental Role of Financial Intermediaries (Banks)

Liquidity Issue

- Enable individuals to invest for longer periods than savers want to have their money invested: Pool Risk – credit and liquidity

- Borrow short / lend long: significant role in creating economic growth

- When cannot sell assets, financial institutions can not meet liquidity requirements

- Bear Stearns: solvent but not liquid
  - Not happened in many years

Fundamental Role of Financial Intermediaries

Leverage

- Banks are leveraged 10 to 1
- Investment banks leveraged 30 to 1
- Federal Reserve has “encouraged” increased leverage to fund government debt
- SEC established capital rules for investment banks using mathematical models
- Pre-Fed banks leveraged 1 to 1
- Even conservative banks had to leverage to be competitive

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:

How Did Residential Real Estate Markets So Significantly Impact Capital Markets

- Subprime mortgage crisis
- Failure of rating agencies: S&P / Moody's / Fitch: Government sanctioned (SEC)
- Market could not evaluate risk: no liquidity
- Auction Rate Municipal Bond Market
- Ambac, MBIA – Insurance / mortgage and municipal
- S&P, Moody's, Fitch rating of AMBAC, MBIA – not reliable
- Lack of liquidity / bonds not marketable at almost any price
- BB&T has plenty of money to lend

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
- Random changes in the balance sheet should not impact operating earnings
- 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 (at year end 2009)
- SEC (government agency) makes accounting rules: i.e., <u>laws</u>: 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
  - <u>Only possible with FDIC Insurance</u>
- 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 prime 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-<u>pragmatic</u> thinking: i.e., short term: irrational/lacks integrity/evasion/arrogance

Another Factor:
Misuse of Credit Instruments

- CDO / SIV / CDO^2 (Double Leverage)
  - Failure of rating agencies (S&P, Moody's & Fitch): Government sanctioned
  - Investment banks hold risky "strips" (traunches)
- Credit Default Swaps (CDS)
  - AIG
    - Rating agencies
    - Failed mathematical models
- Investment banks / state government pension plans / public university endowments invest in hedge funds who speculate in CDS and short stocks
- Why Save AIG??
  - Insurance subsidiaries safe
  - To save Goldman? (crony capitalism or system risk?)
  - Saving AIG has done more damage to financial systems then letting Lehman fail
  - Incentive issue trivial compared to massive "subsidy" for foreign banks

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**

- **<u>Bank Regulators have tightened lending standards!</u>**
  - **Talk one game / play another: unequal incentives for regulators**

Failure of Government Policy
SEC

- Sanctioning Rating Agencies
- BASEL rules for investment banks
  - Significantly increased leverage
- Misregulation
  - Sarbanes Oxley
  - Meaningless, confusing, detailed disclosure
- Short sale rules: not enforced
- Ownership of accounting system
  - Reliance on rules instead of principles
  - Fair Value
  - <u>Loan loss reserves</u>
- Artificially created fluctuations in accounting results

Why Markets Initially Perceived “Bailout” Programs Would Not Work

- **HOPE Program creates perverse incentives with 20% “haircut” from appraised value which could drive real estate values lower: i.e., below affordable: Help few borrowers**

- **TARP #1 Program creates major issues:**
  - **How will mortgage bonds be priced**
  - **Will government foreclose on houses or not**
  - **Failure to foreclose will encourage many other homeowners not to pay mortgage: huge potential problem**
  - **If foreclose, where are resources to liquidate houses**

Why Markets Initially Perceived "Bailout" Programs Would Not Work

- Programs are totally focused on marginal borrowers – not fundamental residential housing deflation problem
- Banks are motivated to help borrowers that can be helped
- How many marginal borrowers are really victims?
  - Did not put anything down
  - Bought bigger houses
  - Choose pick-a-payment: after offered fixed rate
  - Speculators: even if live in house
- What about individuals who did not make unwise investments: my son vs. my other relative
- More rational to reward the prudent instead of imprudent: tax credit

Why Markets Initially Perceived "Bailout" Programs Would Not Work

- Moral risk is extremely important:
  - Example from BB&T Mortgage Servicing

- There are <u>no</u> meaningful benefits to healthy financial institutions from HOPE and TARP #1 programs – <u>in fact they create risk for healthy companies</u> because they do not help residential real estate markets

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 <u>All</u> 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
- <u>Self fulfilling spiral down</u>
- Price instability (both inflation and deflation) is destructive: causes economic miscalculation

TARP #2

- Capital injection in banks: <u>investment must be repaid with interest</u>
  - 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)
  - 5 financial institutions "too big to fail" (maybe more)
    - 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 should provide liquidity to core financial intermediaries
- <u>Let</u> <u>market</u> <u>correct</u>: Do not rescue any more companies
  - 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
- Residential real estate tax credit could have cured problems at dramatically less cost
- Do not introduce <u>any</u> 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: <u>Federal</u> <u>Reserve</u>
  - By far primary causes of current financial crisis is government policy, not market failure: <u>Federal</u> <u>Reserve</u>, FDIC, Housing Policy, Freddie / Fannie, SEC, HUD

- Attack on "wealthy" is an attack on the <u>productive</u> – 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 <u>systematically and materially raise capital requirements</u> for banks (especially "start ups")**
  - **Reduce FDIC insurance back to $100,000**
- **Make it <u>explicitly</u> 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” – <u>creating win/win relationships</u>

- <u>Atlas Shrugged</u> (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 late 2009– followed by period of slow real growth – growth rate below economic potential – recent government "incentive" programs reduce long term productivity – <u>stagflation</u>?

What Happens In The Long Term

- Depends on us
- Continuation of Altruism / Pragmatism / 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


TEAMWORK
PRODUCTIVITY
SELF-ESTEEM
PRIDE
JUSTICE
INTEGRITY
HONESTY
REASON
REALITY
INDEPENDENT THINKING
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