



Putting the Crisis in Perspective for Investors

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One of the most difficult tasks for the asset management community in the current crisis is communicating to clients who are not investment professionals, exactly what is going on in financial markets and how things came to be as they are.

On September 30th, I received a question from a friend in Vermont on the nature of the financial crisis. I wrote a series of emails in response which have been consolidated below. I hope it will provide a few ideas of how to communicate with your own constituencies.

Question

If you have a moment, here's a question I keep returning to every time I hear pundits and prognosticators say the cause of the fiscal crisis is the sub-prime lending mess and/or the lack of liquidity in the market. This logic leads one to believe that solutions include purchasing bad assets or infusing capital into the system some other way. But, isn't the mortgage mess really just a symptom of the American tendency to live beyond one's means? The solutions mentioned above don't address what strikes me as a deeper, broader, and more culturally engrained problem – that we aren't able to pay for everything we want and then purchase. Following that logic, the term "crisis" is a misnomer as it implies a sudden (often unexpected) problem that can be remedied in a relatively brief period of time. Seems to me that the real way to solve this problem is for both the government and individual citizens to reduce the amount of debt they carry and to be realistic about their capacity to repay future debts they are willing to incur.

Answer

I agree most people live beyond their means, but that's not the cause of the immediate crisis.

The immediate issue has to do with liquidity. Let's say you own a house that is appraised at \$300K so that is what you think it is worth. Implicit in the appraisal is the idea that when you decide to sell, you give the selling process the normal



amount of time to find a buyer (typically several months). Let's also assume you have \$200K mortgage, which at 2/3 the appraised value is lower than the typical mortgage.

Now let's assume that one of your children is kidnapped and the kidnappers demand a \$50K ransom within 24 hours. One way you could try to come up with the cash would be to sell the house, but given that you need to find a buyer, do the paperwork and get the cash in hand in 24 hours, you're going to have a very tough time finding a buyer for the house at \$300K. In order to get a quick sale, you have to offer a lower price to induce a buyer to come forward immediately to snatch up the bargain. If you can find a buyer in 24 for at least \$250K, you're OK. You lose some equity in the house, but you get your child back which is what you care about. But if you can't find a buyer in 24 hours for at least \$250K, you're stuck.

The US banking system has been in a similar position for many months. The banks hold lots of shares in packages of bad loans and an even larger number of loans that might go into default in the future. The value of these loans is certainly less than their face value, but how much less depends a lot on how fast you try to sort the problem out. If the banks could sort this out slowly over a period of years, they can hold the questionable loans and collect most of the money that they are owed. There would be some big losses but nothing catastrophic.

On the other hand, if depositors panic and withdraw their money from a particular bank, that bank has to sell the loans to other banks and investors at a big discount to come up with the cash needed. If our bank sells the loans off at a big enough discount in order to get immediate cash, the banks will lose so much money that the bank's reserves are wiped out, and the bank is out of business. If the banks go out of business or are impaired, there will be no new mortgages so real estate prices drop even more, making the whole thing worse.

The real problem is that when banks buy shares in packages of loans (called mortgage backed securities or MBS) instead of making individual loans one by one, they really don't make an effort to evaluate the creditworthiness of the loans. Instead, they depend entirely on the credit rating of the MBS which is assigned by a credit rating agency like Moody's or Standard and Poor's. Both Moody's and S&P did a horrible job rating the credit worthiness of MBS over the past ten years. The problem is that since MBS shares are spread around among thousands of banks and investors, no one wants to pay the rating agency to do their work. Instead, the mortgage broker representing the borrowers ends up paying for the rating, so the rating agencies have a huge business incentive to be optimistic. Imagine if you went to a store and applied for a credit card, and the store relied on a credit report that you yourself provided on your creditworthiness!



Moody's did most of the rating of MBS and there were two major technical problems with their approach. The first was that almost all the data they had to study on residential mortgage defaults came from government records from the 1970s onward. There weren't any computerized records of earlier events.

However, there has been no three month period in the last thirty five years when the average house price in the US has gone down. All the analysis that was done assumed that house prices never go down. This is just wrong. There were certainly periods prior to the 1970s when this happened like the Depression of the 1930s, and there have been many periods when particular regions of the country had house price declines (New England houses went down an average of 14% from 1981 to 1984). Over the past two years, house prices in Miami are down 30% (but are still 90% higher than in the year 2000!).

The second problem in the rating methods had to do with the idea of diversification. It was assumed that if the loans were from different geographic areas and types of houses, the lender was not putting all their eggs in one basket and hence it was safer than holding loans from just one type of property in one geographic area. All else being equal this is true. However, Moody's used a method called "diversity scores" to rate how well the risks were spread out in a particular group of loans. The diversity score method was deeply flawed and always has been. In 1998, I wrote a research paper on corporate loan packages pointing out those flaws, but it never got much attention. [Here](#) it is if you want to read it.

The longer term issue of how we got into this mess is really pretty simple. There are two root causes. The first is that in the US, different kinds of financial institutions (banks, investment houses, and insurance companies) are all subject to regulation by different government agencies that have inconsistent rules. For insurance companies, the rules vary greatly state to state, with many states (including VT) being relatively lax. With the inconsistencies in the rules, there are lots of loopholes so that if a particular kind of institution can't do a transaction because it is too risky, some other kind of financial institution probably can do it. It got so lax that mortgage fraud via "cash back under the table" deals was commonplace.

The second cause of the problem is more in line with your thinking. As a society and a government, we've put a lot of emphasis on the ability to have material prosperity. A lot of this was just terribly frivolous, but not all. Federal legislation encouraged mortgage providers such as Fannie Mae and Freddie Mac to effectively act as cosigners on mortgage loans for people with poor credit. It was considered a societal achievement that lots of relatively poor people were able to buy homes in recent years. This has contributed to decreased crime rates and improved schools in bad neighborhoods. Imagine if your home state of VT decided as an environmental measure to try to encourage people to ride buses



instead of driving. To do this, we remove the speed limit for buses on the interstate highways as of May 1. Given that buses could now go from Burlington to Boston in two hours (at 100 MPH), lots of people would ride the buses. The environment truly benefits as the number of cars declines, and the bus companies are very profitable, so they make large contributions to political candidates to show their support. Everybody will be happy until the weather gets snowy, when bus after bus crashes killing all the riders.

Once regulator authorities decided to allow Lehman Brothers to go bankrupt, as opposed to arranging a “shotgun” wedding as they did with Bear Stearns and Washington Mutual, banks around the world finally realized that their common practice of lending to each other with little regard to the creditworthiness of other banks was unsound. Clearly, the government wanted to send a message to Wall Street investment banks that they could not expect to always be rescued from their own greed and stupidity. Inter-bank lending dried up and all banks were temporarily forced to cut back on making loans as they were no longer assured of being able to borrow from other banks whenever they were short on cash. You can think of the world banking system as a car engine with no oil. Without the lubrication of inter-bank lending, the whole system froze up. The rescue plan put in place by various governments around the world involves purchasing shares in banks so everyone is confident that banks will be in financially sound condition, so that conditions normalize over time. Some countries like the United Kingdom are putting massive money into this effort, as their real estate prices rose the most in recent years, so they are in the greatest danger of property price declines creating a serious general recession.

One other thing I should mention is that even with the additional financial strain of this mess, the national debt of the US, while huge is still well below average in terms of countries around the world. Even with some kind of big bailout for the mortgage crisis, the US national debt is only around 40% of annual GDP. Almost every European country is above that, and many like Italy are close to 100% (there are arguments everyone in Italy cheats on taxes, so the situation is not as bad as it looks officially).

The other bright side of the situation is that large US corporations are swimming in cash. The long term historic average is that big companies keep about 8% of their assets in cash and equivalents. Today, US corporations have an average of over 20% of their assets in cash and equivalents. As such, corporate reliance on bank loans is very low, so problems in the banking sector shouldn't impact large companies (and employment) very much from tight credit. Of course, companies may suffer substantially from decreased demand from consumers who are less able to buy on credit.



The bigger long term problem for the US is that because of the cost of imported oil and manufactured goods, an unusually large fraction of our national debt is held by foreign citizens and countries. They do this because US government bonds are still safer than anything else available. If foreign citizens thought the US was no longer safe (very unlikely) interest rates could go up a lot in the US.

Our other big problem in the US is that the current scheme for Medicare and Medicaid is financially unsustainable, since it commits the federal government to pay for at least 80% of whatever health care costs eligible citizens choose to incur. There are no limits on how much an individual can spend as long as they are willing to handle the co-payment expenses (which are zero in many cases anyway). Hopefully, we'll end up with Federal government doing what states like Massachusetts and Vermont are already doing: getting every person enrolled in private health insurance, even if the government has to pay the premiums. At least the insurers and HMOs have procedures in place to control spending.

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