



The Obama Administration and the Credit Crisis

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On November 7, 2008, the Harvard Business School hosted a panel discussion on the current financial crisis. Participants shared their outlook on an Obama administration's impact on leadership, the financial markets and real estate.

The discussion was lead by four professors:



Nabil N. El-Hage is a Professor of Management Practice at Harvard Business School. Since obtaining his MBA from HBS in 1984, El-Hage has worked in private equity and venture capital with TA Associates and Advent International. He gained operating experience as CFO of Back Bay Restaurant Group, and he has been on the HBS faculty since 2003.



Jay W. Lorsch is the Louis Kirstein Professor of Human Relations at the Harvard Business School. He is the author of over a dozen books, including *Back to the Drawing Board: Designing Boards for a Complex World* (with Colin B. Carter, 2003), *Aligning the Stars: How to Succeed When Professionals Drive Results* (with Thomas J. Tierney, 2002), and *Pawns or Potentates: The Reality of America's Corporate Boards* (1989). *Organization and Environment* (with Paul R. Lawrence) won the Academy of

Management's Best Management Book of the Year Award and the James A. Hamilton Book Award of the College of Hospital Administrators in 1969.



Arthur I. Segel is the Poorvu Family Professor of Management Practice in the Finance Unit at Harvard Business School. He was co-founder in 1982 and co-owner of TA Associates Realty. He also served as vice president at Boston Properties prior to that, and as Deputy for Finance and Administration at Massport under Governor Michael S. Dukakis.



Bill George is Professor of Management Practice at Harvard Business School, where he is teaching leadership and leadership development along with several executive education programs. He is the author of a new best-selling leadership book, *Finding Your True North: A Personal Guide*. His previous two books, *True North: Discover Your Authentic Leadership* and [Authentic Leadership: Rediscovering the Secrets to Creating Lasting Value](#), were also best-sellers.

Housing and the Credit Crisis

El-Hage began the discussion with a recap of the causes of the credit crisis, which we omit — our readers are all too familiar with them. He and Segel both agreed that the housing market is far from bottoming, and the mechanics of the government's bailout are still being perfected.

El-Hage said the government's original plan to buy back "toxic" mortgages was bound to fail. "Just by buying back assets, you have not replenished the capital," he said. Because banks are highly leveraged, the funds would have been insufficient to replenish enough capital to restore lending capabilities.

The revised plan is more thoughtful, El-Hage said. "But the trouble is that it is not enough. Banks have lost \$500 billion, but the talk is that only \$150 to \$200 of \$700 will go to help banks restore their balance sheets," he said. "The politicians are asking why banks are not lending. The answer is simple — they don't have assets on their balance sheets."

El-Hage questioned why banks are being allowed to continue to pay dividends. "Surely they should not," he said, because they are already highly overleveraged, but he expects a big negative reaction from the capital markets if banks cut or reduce dividends. "Strictly from a financial theory point of view, banks should stop paying dividends, but from a market point of view, they should not," El-Hage said.

Approximately 3-4 million homes are now in foreclosure, with another 7 million "underwater" (where the home mortgage exceeds the value of the home), Segel told the audience. Housing problems are now particularly acute for the less fortunate, he said, and there are now 750,000 homeless, a third of whom are veterans, many of the Iraq war.

"Something has to be done to keep people in their homes," Segel said. He advocates figuring out ways to turn home payments into leases without evicting homeowners and keeping payments to a third of income, but including a buy-



back option. As of June of this year, he noted, there were four million households spending 50% or more of their income on housing.

Segel said that some segments of the housing industry are “in denial” of the extent of the crisis. REITs, many of which have lost 70-90% of their value, are “getting clobbered and lots of them will disappear.”

Until we figure out how to restart lending, we will have serious problems,” he said, adding that 70% of all real estate is levered. On the commercial side, Segel expects conditions to deteriorate quickly, beginning with office space, followed by retail, and then multi-family real estate.

During the 1991 crisis, Segel said the industry adage was “stay alive until 95.” Now the mantra is “heaven will come in 2011.” The industry is figuring out how to survive for the next three years.

Priorities for the Obama Administration

The Obama administration should begin with a massive focus on energy, infrastructure and education, Segel said. He suggested providing government-funded college education, to be repaid through income tax deductions, citing a similar program in Australia. “Clearly, dollars should go into alternative energy,” Segel said. Physical infrastructure spending will have the most impact on real estate prices, he noted, adding that now is the time to think about rail transportation in a “more thoughtful way than ever before.” He believes such initiatives are the best way to conserve energy. He also suggested changing zoning codes to allow people to live closer to cities in order to reduce transportation costs.

Former GE CEO Jack Welch, a McCain supporter, recently spoke at HBS and said that Obama “has turned out to be a great leader.” Going forward, there will be plenty of challenges to test that leadership, said Lorsch, and there are dangerously high expectations for the new administration. “Whatever skills he has as a leader, he is not a miracle worker,” Lorsch said.

Based on the themes of the campaign, Lorsch said, it is pretty clear Obama will focus on jobs, especially for the middle class. But, realistically, the priority will be to prevent massive unemployment. As an economic philosophy Lorsch calls this “bottom-up employment.” Putting many more people to work will be difficult.

Lorsch agrees the country’s infrastructure is broken, but he questions how improvements will be financed.



One of the more curious debates in the campaign, Lorsch said, concerned international trade. Lorsch sees a problem with NAFTA, in that it has cost jobs in US, but he cautioned that restricting trade will impair economic growth.

New Models for Leadership

“We are at the end of an era,” said George, who pointed to a “clear failure of top-down leadership.” The Bush administration failed, along with many financial institutions, because key leaders put their own interests ahead of the institutions they served, he explained. Such self-interest was the cause of the Enron failure and plagued Wall Street in the current crisis. A new era of collaborative management is beginning, according to George, and such a shift is the only way to solve our current problems. In the last five years, he says, the most effective CEOs, such as Jeff Immelt of GE, have embraced a collaborative style.

On a global level, George argued that other nations must be involved to solve the world’s biggest problems, such as energy dependence and global warming, and solutions will not come from the top down. “It will take 10-30 years to develop the technology and the best solutions for energy efficiency,” he said. George said “the US is not putting nearly enough energy and money into innovation,” adding that venture capital funding has shut down.

“I don’t believe that saving old industries will create new jobs,” George said of the troubles in the automobile industry. “We are better off funding the Googles of the future.”

George said he was recently asked by the *Wall Street Journal* what Barack Obama can learn from the business community. He said a better question is “What can business learn from the Obama campaign?” The lessons of the campaign are the effectiveness of constant and consistent messaging and alignment along a common set of values. George also pointed to the advantages of using the most advanced internet tools. “This was a way to get their message out to all people quickly, and not in a hierarchical way,” he said. It aligned people around a common mission and values, and without reserving power for a smaller group. In the long run, for businesses, this is how they can create great customer value,

The only concern George has about Obama’s platform regards the issue of free trade, which he believes is necessary to restore the economy.

Regulation

“The question is not whether more or less regulation is needed, but what is the right regulation,” Lorsch said, and it is unclear who will ultimately be charged with



figuring this out. Boards of Directors and their roles as overseers need to be addressed, according to Lorsch, who said the failure of boards at least partly explains excesses in executive compensation.

El-Hage agreed that the answer is not necessarily more regulation; it is smarter or sometimes less regulation. “Clearly, the unbridled and excessive leverage which allowed hedge funds to borrow at Treasury rates and lever at 40- to 50-times was bound to lead to a disaster,” said El-Hage. Even a “minor hiccup” in asset values forces the unwinding of large positions.

He also cited the multi-trillion market in derivatives, which stopped serving a hedging purpose and became a form of “casino gambling.” El-Hage called for minimum disclosure requirements so that, if a Bear Stearns-like failure happens on a Friday and requires resolution over the weekend, the problem will not be compounded by a lack of information.

“An ounce of regulation is worth a pound of bailouts,” said George, who fears that the pendulum will swing too far toward over-regulation. If that happens, he said, “a lot of us will get hit, and it will strap everything down.” George agreed that Boards of Directors need to step up, particularly with regard to compensation, “otherwise the Government will take over.”

Industry concentration and becoming “another Europe”

Increased industry concentration and the “too big to fail” syndrome are concerns for Segel, who is specifically wary of concentration in the banking system. At a macro level, he wants new administration to concentrate on increasing wealth equality, since 49% of the nation’s wealth is in the hands of the top 10% of its population. In recent decades that number has been around 30%, and today’s wealth inequality is comparable to that in the 1920s.

El-Hage said we are vilifying business in unprecedented ways, when instead policy should be focused on increasing productivity. The current attitude “will turn us into Europe,” he said. “As long as new administration does not come out with an attitude to punish business, we should come out okay.”

Taking an approach guided by “what is best for the industry and not what is best for individual companies” is necessary, George said.

If the government injects money into the automobile industry, the industry must move away from gas-guzzling vehicles, said El-Hage. “There needs to be a quid pro quo,” he said, and the auto industry needs to innovate and compete based on efficiency. He favors a gas tax — a “huge” one — but acknowledged that it is not politically attractive.



Europe has already achieved 40mpg standards and are committed to 70mpg, George said.

“Clearly Europe has its problems, but we can learn from them,” said Segel. He noted the Swedes have turned education over to private companies to reduce costs. “The notion that there is something wrong with Europe is mistaken,” he said.

Reforming the Tax Code

Simplifying tax code should be a goal, according to El-Hage, but a common suggestion to do so — a flat tax — is “directionally right but too unrealistic in this day and age.”

Capital gains should be taxed based on how long assets are held, George said. One proposal under consideration would eliminate capital gains taxes for founders when they sell their companies. “Anything that supports startups and gets them moving by creating jobs strengthens our national competitive advantage,” George said.

Executive salaries should be structured to replace cash with equity, with incentives to hold assets for a longer time and monetize at lower capital gains rates, said George. “This will get executives focused on long-term results,” he said.

The Prospects for Inflation

Deflation has been in the media a lot more lately and is the concern in the short-term, according to El-Hage. “But every country that has borrowed as massively as we have has ended up with high inflation,” he said. In the aggregate, our borrowing is still modest relative to our GDP. But the slowdown in consumer spending and corporate activity will add to the deficit. “Looking three years down the road, my biggest worry is inflation and currency devaluation,” El-Hage said.

Longer-term effects of inflation will depend on how our trading partners behave, according to El-Hage. “As long as oil exporters buy long-term Treasury securities with low interest rates, we will be okay, but this is a big question mark,” he said. The possibility of hyperinflation could arise if our trading partners decide to diversify.

George noted we are fortunate to be able to trade with so many countries in dollars.



Segel expects much higher inflation than he has seen in his lifetime. “Right now, the oil exporters are looking for other ways to invest, including places like Africa, and this will hurt the US and the dollar,” he said.

Advice for the Next Administration

The next Treasury Secretary will face the greatest challenges in the history of that office, according to Lorsch.

George likes NY Fed President Timothy Geithner for the job, based on the way he conducted himself during the crisis. “He has extremely good relations with Paulson, Bernanke, and Wall Street, and understands the problem in depth,” he said, adding that “I would bet on him.”

Segel supports Geitner, and also likes former Treasury Secretary Larry Summers because he “thinks in a global way.”

One of the real innovations of the Clinton years, according to Lorsch, was the coordinated way in which the Council of Economic Advisors worked with each other.

George hopes to see “a lot of fresh faces, with tremendous potential, who are not politicians.” He cautioned against “recycling old people” and to get people to think differently in order to take government to a new era.

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