Calls for more transparency have been a rallying point for investors and regulators amid the ongoing credit crisis, but recent actions taken by the Treasury and the Federal Reserve are anything but. Whether through practical ignorance of the challenges average families face or measured intent, the Fed (with bipartisan support) has engineered an expensive, immediate transfer of the credit crisis’ costs that is both inequitable and regressive.

Of the Fed’s rejection of direct support for Lehman, Treasury Secretary Henry Paulson commented: “I never once considered that it was appropriate (emphasis added) to put taxpayer money on the line in resolving Lehman Brothers. … We do not take lightly ever putting the taxpayers… on the line to support an institution.” Setting aside the failure to define the criteria for “appropriateness,” such statements either reflect naivety, insensitivity or blatant deception. They imply that taxpayers suffered less cumulative economic damage than they might otherwise have had the government not stood idly by. Paulson’s public position is form over substance, and the questions Americans should be asking are:

- What is the appropriate role of government when it comes to intervention in private markets?
- What is the true cost of the Government’s role to date?
- Setting aside the labels of “federal spending” and “tax dollars,” who, at the end of the day, is paying the bill?

The Savings & Loan crisis of the early ‘90s provides a ready analogy, and cost assessments then appear to have been far more transparent. Institutions were closed or merged, assets were sold and the calculations of the aggregate shortfall, while probably oversimplified, were a question of simple math.

Now let’s take a look at the structure and costs of the Fed and Treasury’s response to the current crisis:

- A series of rapid-fire interest rate cuts totaling 3.25 percent that began in the fall of ‘07
- Opening up the reserve window to Investment Banks and expanding the collateral that could be pledged to secure borrowings

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• The selective bailout, seizure, acquisition or affirmative non-intervention with respect to large distressed financial institutions with global presence and impact

There is universal consensus that the bailouts to date will have virtually no impact in stabilizing the U.S. housing market or mitigating related losses, even though it is the distressed condition of the housing market that has ignited the current crisis and infected a broad base of institutions and asset classes. The government’s actions have been driven by two specific, stated objectives: (i) stimulating consumer spending and (ii) managing the fallout from failing institutions whose downfall posed systemic risks (these are often referred to as “too big to fail”). Judgments were ostensibly guided by the best interests of taxpayers and made to avoid the moral hazard associated with government bailouts for privately owned enterprises.

Let’s examine the costs and benefits of the government’s actions:

**Interest Rate Cuts**

There is no dispute that, prior to the government seizure of Fannie Mae and Freddie Mac, which I’ll address later, the precipitous drop in short-term interest rates did not translate into lower mortgage rates for homeowners. Nor did it otherwise provide material benefits to the typical consumer. In fact, at various times during the one-year period since the aggressive campaign to cut short-term interest rates began, home mortgage rates were actually higher in year-to-year comparisons.

In support of its monetary policy, the Fed’s public posture was that consumer spending, a primary driver of economic growth, had to be propped up to avoid a recession. In reality, the spending power of consumers was severely compromised, as many American households were forced to deal with increasing costs of household necessities fueled by the dollar’s foreseeable decline. These same households also had to deal with lower rates on their savings. Thus in the final analysis, the costs were disproportionately forced on middle-class and moderate-income taxpayers, many of whom are retirees. What’s more, unlike the lag periods associated with changes in tax policy or increasing deficits, the cost impact has been immediate and has skirted the political debate regarding the distribution of the burden.

Experts have estimated that the increase in the cost of gasoline alone burdened consumers well in excess of $100 billion during the relevant period. Together with cost increases for food, utilities, and household necessities, the total costs could well exceed hundreds of billions of dollars to date. No doubt, a roomful of
economists could estimate the total costs associated with the decline of the dollar, albeit with a wide margin of error. But any such results are unlikely to be easily understood by the affected taxpayers, and they would therefore be politically benign.

On the other side of the equation, the beneficiaries of the rate cuts have been the banking system and other financial institutions. The series of rates cuts immediately lowered the cost of borrowing for many financial institutions. In a declining rate environment, most banks benefit immediately from a reduction in borrowing costs and deposit rates, but there is a lag in any related declines in the average yield on interest-earning assets. This net benefit is referred to as margin expansion, and it goes right to the bottom line; there is no overhead cost associated with the increase in net interest margin. The increase in net interest margin, then, has been a subsidy or gift provided by the Fed. Its effect was to cover or partly offset the quarterly additions to loan loss reserves (an expense) due to the continuing credit deterioration of loan portfolios held by these same institutions. Take a bank with $100 billion in interest-earning assets (loans, securities, etc.). Assuming the immediate benefit to net interest margin was 50 basis points (1/2 percent), then the benefit to net interest margin for the fiscal quarter would be $125 million ($500 million per annum). If the bank chose to take on additional borrowings at the reduced rates to purchase securities at the wide spreads reflective of prevailing turbulent markets, an even greater economic benefit could be realized.

Under traditional circumstances, the additional funds would be used to make loans. In the prevailing environment, however, every dollar is needed to offset losses and shore up reserves and capital. Multiply the above example by the trillions in assets, liabilities and deposits on the balance sheets of our financial institutions. It is logical to conclude that the contribution to net interest margin nationwide amounted to hundreds of billions of dollars.

In the absence of the margin expansion described above, the recent financial performance of our banks would have been even worse, and we might have risked facing even more failures. It is not the prudence of the measures taken that are at issue, however, but rather the opaque nature of the indirect government assistance. Also of concern is the more discreet and immediate transfer of costs to middle-class Americans without allowing the democratic process and voter sentiment to weigh in on the economic distribution of the burden.

**Expanded Access to Fed Funds**

Here again the debate is not over the propriety of the action but the lack of information about the nature and value of the pledged collateral (which included
securitized leveraged commercial loans), and its true risk to taxpayers. There still is not clear disclosure to the public regarding the categories of pledged collateral, the process for marking the collateral to market as would be required in the private sector, and any existing exposures. These exposures may ultimately be the impetus for future bailouts, depending on the extent to which the government would be taking losses on pledged collateral anyway should the related institution face a liquidity crisis.

Bear Stearns, the GSEs, Lehman and AIG

Clearly, the most controversial issue is the apparently disparate treatment by the government of institutions facing perceived or actual immediate crisis. It is hard to justify government intervention into the affairs of private enterprise unless such intervention is necessary, and limited in scope to surgically address the circumstances driving the aid.

While the above criteria leave much room for partisan debate, partisanship has not appeared to be an issue with the government’s crisis management. The problem is that bipartisan approval during an election year is likely to be politically motivated and not representative of the best interests of the general public. Moreover, the motivations and underlying rationale for the government’s decisions lack the transparency of fair and honest disclosure, especially to taxpayers.

Bear Stearns: The acquisition of Bear Stearns by JP Morgan and the government’s role in facilitating that transaction are the most transparent of the actions taken so far. In the name of averting systemic risk to the financial markets, a deal was brokered to acquire the company, with the Fed guaranteeing $29 billion of Bear Stearns’ most toxic assets. While the deal was originally negotiated at around 3% of book value, the price quickly moved to 15% of book value to ensure closing. Theories that have been tossed around to explain the increase in price include shareholder threats to file bankruptcy and JPMorgan’s realizing that getting the deal done quickly might be wise given its sizeable exposure to credit default swaps. For taxpayers, the losses realized on the toxic assets will reveal themselves over time, and the costs included in the federal budget — simple math — will be distributed with the full vetting of the political process.

Fannie Mae and Freddie Mac: The decision by Treasury to place the GSEs into conservatorship is perhaps the most controversial of the actions taken to avoid systemic risk. A comprehensive discussion of the GSEs is beyond the scope of this commentary, and the debate over the role of the GSEs has been going on for years. But that debate was short circuited without resolving the issues that were concurrently in the hands of Congress. While this might prove appropriate if the circumstances were as dire as presented, there is evidence that is not the

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case. Moreover, the structure of the takeover raises serious questions as to its motivation and the obligation of government to minimize the damage to shareholders where possible.

Given the government’s overt statement that it would explicitly stand behind the GSEs, the chosen form of intervention hardly seemed necessary. In fact, it was Treasury that stood in the way of the GSE’s ability to shore up its capital base by raising the possibility (ultimately realized) that government intervention might take the form of equity, creating the type of uncertainty that would logically discourage outside investment. Other considerations that appear to have been ignored:

- The GSEs were in compliance with mandated regulatory capital levels. The fact is that their regulators (whether or not the product of an effective lobbying machine) allowed for considerably high leverage and the attendant thin capital levels.
- The stress on their capital levels was not primarily of the GSEs’ doing. Instead it was a direct byproduct of the excesses of the private markets, as unregulated institutions seized market share to provide funding under substantially easier credit terms than those required of the GSEs. The oversupply of foreclosures affects the loss severity for every lender, but in this case, the oversupply was driven by the substandard collateral supporting private-label (non-GSE) mortgage-backed securities.
- Although the GSEs’ capital base was admittedly thin, it is somewhat of an exaggeration to compare it to the total of $5.5 trillion of total portfolio and guarantees outstanding. Large segments of the loans guaranteed or held in portfolio were originated during the refinance boom prevailing throughout 2002-2004 and are secured by “pre-bubble” collateral with substantially diminished exposure to losses.
- There is little dispute that the GSEs played a dominant role in the transformation of America’s housing market into one that is unparalleled worldwide in terms of promoting accessibility, standardization, and liquidity.
- Virtually no one believes that the conservatorships will provide relief to the ailing housing markets.
- Unless the treasury was inept in its ongoing assessments or intentionally opaque, there was no imminent danger of failure. The only danger was that their capital levels might become thinner should additional loss reserves outpace earnings capacity.
- The GSEs have played an integral role in the purchase of fixed-rate loans from banks, one that allowed banks to manage the interest rate risk that drove the financial crisis of the early ’80s.
• The government already controls HUD as a vehicle for intervention in the housing finance market. It would seem that HUD’s historical loss of market share, inability to drive innovation, and the burdensome regulatory process under which it operates handicaps its ability to respond in a timely fashion to market conditions and market-specific needs. HUD already exemplifies the ineffectiveness that would prevail in a market controlled by day-to-day government intervention. There is often lip service given to the value of public-private partnerships, and the GSEs stand among the few examples of consummate success in that category, despite some obvious flaws.

• There were no overt signs of permanent impairment to the GSEs’ future revenue base in their business model. Although the viability of mono-line finance companies and investment banks clearly faced twin headwinds in the form of continuing credit losses and compromised revenue-producing capacity, the GSEs face the tailwinds of greater market share coupled with pricing power that was already being exercised. That prospect of achieving greater margins while still serving the liquidity needs of the market may in fact have generated adequate earnings to mitigate future loan losses.

While concerns over the GSEs ability to balance their public mission with shareholders’ bottom lines are valid, they could have been addressed surgically. Similarly, the government could have structured the announced explicit guarantee as a credit line (for example, at 10%) that would be superior to subordinate debt, preferred and common shares. Such an announcement would have addressed any crisis in international confidence without unnecessarily impairing the rights of shareholders.

Shareholders are always punished in the form of dilution when additional and presumably expensive private capital is raised under crisis conditions. But the government deliberately chose to play the role of investment banker by acquiring economically viable entities at 2.5% of book value and suspending all dividends, decimating the value of common and preferred shares. Even the shareholders at Bear Stearns received greater consideration at 15% of book and the opportunity to recapture value in the future.

To put a new spin on an often-used quote: If it ain’t mostly broke, don’t fix it with a sledgehammer. Why were the measures taken so drastic?

The answer may lie in an IRS ruling, issued concurrently with the conservatorships, that has received relatively little attention. IRS Notice 2008-76, which was issued on Monday, September 15, 2008, essentially allows the two government-sponsored enterprises to retain their accumulated tax losses.
(referred to in tax parlance as NOLs) under circumstances where these future tax benefits would be extinguished for most other companies under similar circumstances.

Under present law, when there is a change in control of a corporation with substantial NOLs, the ability of an acquiring company to take advantage of those NOLs is severely limited. The law's intent is to prevent profitable companies from acquiring target companies as tax shelters.

Given the magnitude of the crisis at hand and the ongoing concerns surrounding Lehman, WAMU and AIG, why would the preservation of NOLs even be on the mind of the Secretary of the Treasury? It is hard to imagine any urgency to preserving these tax losses under the circumstances. The only logical conclusion is that Secretary Paulson fully understood the economic viability of the GSEs as private enterprises and that the NOLs would be absorbed by anticipated future profits. This would preserve additional value for the government’s resale of its 80% equity interest — all at the expense of existing shareholders. In the case of the GSEs, the principal shareholders are some ten thousand middle-class employees and tens of thousands of other middle-class Americans who hold these once-blue chip stocks in their retirement or savings portfolios, either directly or through mutual funds. Again, there is a unilateral shifting of the economic burden to middle-class taxpayers.

**Lehman and AIG:** Tantamount to playing a shell game, the government appears to have arbitrarily decided to let Lehman fail in the name of averting the moral hazard. No explanation is offered as to how Bear Stearns’ collapse presented greater systemic risk than Lehman Brothers’. Moreover, rather than play the role of neutral observer until the very end, the government preemptively announced its unwillingness to throw a lifeline or take over the firm, virtually assuring the absence of a bid for the complete company. The possibility of a government takeover might have encouraged bidding, rather than a picking-apart of the pieces in bankruptcy. Under the circumstances, it made no sense for Barclay’s to bid for the company until after the inevitable bankruptcy was filed. Again, the burden is disproportionately borne by middle-class employees, retirement plans and savings.

AIG, on the other hand, presented a reasonable conclusion of systemic risk in light of its huge exposure to credit default swaps — the government rightly had no appetite to play Russian Roulette with the unwinding of CDS on that magnitude. As another blue chip company with over 160,000 employees and tens of thousands of middle-class shareholders through 401k plans and savings, the brunt of the economic cost for its woes falls on middle-class taxpayers. At the present time, AIG shareholders are desperately seeking alternatives to pay off...
the government financing in order to avoid decimation of value to equity and other stakeholders.

Conclusion

In the end, a monumental series of crises unfolded that left the Federal Reserve and the Treasury with decisions that amounted to little more than a coin toss between the lesser of two evils. Government intervention of the magnitude and immediacy seen recently is shocking regardless of political bias. If we are truly to preserve the foundations of our democracy and capitalism, then this type of intervention must be perceived by all as a necessary evil. But the lesser evil is intervention that is accompanied by the kind of transparency that allows Americans to assess the performance of their elected and appointed officials.

Congress is now considering legislation presented by the Federal Reserve and Treasury to fund a massive bailout with the primary objective of restoring confidence in American financial institutions and capital markets and freeing up capital and resources to support a revitalization of lending activity. The costs of this bailout will be in addition to the burden already transferred to middle- and lower-income taxpayers. We can only hope the disproportionate distribution so far will be considered in balancing the costs associated with the credit crisis.

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