

*By Christopher E. Grant*

## **The Great Financial Meltdown**

### Searching for Answers

On October 3, 2008, President George W. Bush signed H.R. 1424, "The Emergency Economic Stabilization Act (EESA) of 2008" into law. Under a newly created Troubled Assets Relief Program (TARP), the Treasury Department, in consultation with the Federal Reserve, the Securities Exchange Commission (SEC), the Federal Housing Regulatory Agency and the Department of Housing and Urban Development (HUD), are authorized to purchase, insure, hold and sell a wide variety of troubled assets, particularly those that are based on or related to residential or commercial mortgages issued prior to March 14, 2008 (the category of "troubled assets" has since been expanded based on a determination by Treasury and the Federal Reserve).

As our readers know, we began chronicling the pending financial tsunami more than a year ago (see our Fall 2007 newsletter "Will the Fat Tail of Sub-Prime Mortgages Dog the Market?") followed by our early 2008 recounting of the government's first installment of the bailout (Spring 2008 Newsletter, "The Fed Bails Out Wall Street, Main Street Pays the Tab," both available at [www.ggmwealthadvisors.com](http://www.ggmwealthadvisors.com)).

In the heated rhetoric of the election cycle battle, the political finger-pointing has run rampant. Rather than join the chorus of shame and blame, **our objective is to carefully examine some of the causes of this debacle** brought on by Washington, Wall Street and Main Street. As Spanish born American author George Santayana wisely warned, **"Those who forget the lessons of history are doomed to repeat them."** Surely, we can't afford such a future recurrence.

## **The Seeds Sown in Washington: Failures in Legislation or Legislators?**

While the parties to this financial tragedy are inexorably linked, some have argued that the seeds were sown with the passage of the Gramm-Leach-Bliley Act (GLBA) in November, 1999. This legislation repealed part of the 1933 Glass-Steagall Act which prohibited banks from offering investment, commercial banking, and insurance services. **The '33 GLBA was deemed necessary to prevent a repeat of the 1920's scams, in which banks made speculative investments, turned debts into securities, and sold them off to unsuspecting investors with the blessing of the bank.** In presenting his rationale for tying this early act of deregulation to the sub-prime meltdown, economist and author Robert Kuttner posits that the repeal of Glass-Steagall "permitted financial supermarkets like Citigroup (the conglomerate that resulted from the combination of Citibank, Smith-Barney, Shearson, Primerica and Travelers Insurance Corporation) to operate any kind of financial business they desired, and profit from multiple conflicts of interest."

While the new legislation may have opened the door to such conflicts, **Kuttner himself admits that the scandals that subsequently pumped up the dot-com bubble of the late 1990's, as well as the Enron era cases, were the result of the SEC and the Bank regulators ceasing to police these conflicts of interest.**

At the opposite end of the regulation spectrum are those who argue that those destructive seeds were planted with the 1977 passage of the Community Reinvestment Act (CRA), which imposed an affirmative duty on federally insured

banks and thrifts to lend throughout the areas from which they take deposits, including poor neighborhoods. As these institutions were subjected to more stringent CRA regulations in the 1990's (including tougher standards under the GLBA legislation), **it is argued that lenders were forced to approve predictably bad loans in order to comply with CRA.** Refuting this position is the statistic generated by the San Francisco Federal Reserve that independent mortgage companies, which are not covered by CRA, made high-priced, sub-prime loans at more than twice the rate of the banks and thrifts. **Just as with the GLBA legislation, the overlooked or ignored catalyst between cause and effect appears to be responsible oversight.**

Often missing from the protagonists lists of suspect legislation and regulation is the Commodity Futures Modernization Act of 2000. **This legislation provided that certain products offered by banking institutions would not be regulated as futures contracts, most notably, credit default swaps (CDS).** This financial instrument, while virtually unknown to most individual investors, has played a major role in the unwinding of the world's financial markets. Simply explained, a CDS is a swap contract in which a buyer makes a series of payments to a seller and, in exchange, receives the right to a payoff if a credit instrument (e.g. bond) goes into default or, on the occurrence of a specified credit event, for example bankruptcy or restructuring.

**The net result of this legislation was the emergence of an unregulated "insurance" market which totaled \$32 trillion in notional value at the end of 2007, with no established clearinghouse.** Unbeknownst to most, the largest government bailout of a private corporation in history, A.I.G., is largely attributable to its issuance of swaps effectively insuring against the default of Mortgage Backed

Securities. Additionally, the claims on the Lehman Brothers default triggered by their bankruptcy are estimated at between \$400 and \$600 billion. With the auction of Lehman bonds fetching only 8 cents on the dollar, the insuring companies are on the hook for the remainder.

While the consequences of either deregulation or over-regulation can be argued according to one's economic or political philosophy, the rationales behind both the GLBA and CRA legislation were legitimate. The failure was in the execution, monitoring and accountability. The same cannot be said for the deliberate non-regulation of the CDS market. **With little or no control over the players in this market, combined with the lack of an organized clearinghouse, the systemic risk to the worldwide financial system is unknown.** Our hope is that this issue will be in the forefront of the Regulatory Modernization Report due to be submitted to Congress by April 30, 2009 under TARP.

### **Wall Street – Risk Taking Matched Only by Arrogance**

The events that led to the demise of Bear Stearns and Lehman Brothers and the orchestrated acquisition of Merrill Lynch by Bank of America also date back further than the 2007 meltdown. According to Lee Pickard, a former SEC official, the Securities and Exchange Commission can blame itself for much of the current crisis.

Back in 2004, the SEC allowed five firms, Lehman, Bear Stearns, Merrill Lynch, Goldman Sachs and Morgan Stanley to more than double the leverage they were allowed to keep on their balance sheets. This ramping up of risk was due to a change in the so-called "net capital rule" that was created in 1975 to allow the SEC to oversee broker-dealers, or companies

that trade securities for customers as well as their own accounts. Under the old rules, broker dealers were forced to limit their debt-to-net capital ratio to 12-to-1 while also discounting the value of their tradable assets (for example, applying a valuation “haircut” ranging from 15% for stocks to 6% for 30-year Treasury bonds). **Under the revised rules, new computer models were applied to measure risk, leading to much smaller asset discounts and resulting increases in their debt-to-net-capital ratios as high as 40-to-1.** The table was set for the high leverage risk taking that followed. As a side note, given recent events, it is beyond belief that the SEC has said that it has no plans to re-examine the impact of the 2004 changes to the net capital rule.

In order to take advantage of this new found leverage, these organizations had to find something to boost their balance sheets. The combination of low interest rates and an escalating real estate market provided the answer. The dominoes in the system weren't really all that complex to start with. Banks or mortgage brokers originated loans, packaged and sold them to Fannie Mae or Freddie Mac who carved them into mortgage backed securities, added their good housekeeping stamp of approval, and doled them out to hungry investors.

**What could have been better: originate a new mortgage, take a fee; package the loans, take a fee; securitize the package, take a fee; sell to an investor, take a fee? Best of all, take no risk since everyone in the chain except the ultimate investor is simply part of the conduit.** With compensation obviously tied to revenues, and no retained risk, the mortgage mill was cranked up to full speed. Predictably, as real estate values continued to climb and mortgage demand grew, credit standards crumbled. Supplied with a pipeline of eager, though often “sub-prime” borrowers, lenders simply became more “creative.” Wall Street obliged by enhancing their

“black box” magic of securitization and, along with their co-conspirators, the credit ratings agencies, transformed as much as 70% of sub-prime mortgage pools into AAA-rated securities.

We all know the ugly ending to this story. What is somewhat strange about the saga is the fate of one of its perpetrators. So convinced of the endless appreciation in real estate, or perhaps so blinded by the size of their bonuses, the “best and brightest” on Wall Street ended up choking on their own cooking, as they oftentimes retained the riskiest slices of their own securitized pie. **While excessive leverage and uncontrolled risk-taking have always been ingredients for disaster, the new element in the equation was the complexity of the mortgage securities where even the most sophisticated institutional investors clearly didn't understand the risk structure of their holdings.**

There are far too many guilty individuals in this daisy chain of folly to list. However, one representative example may serve to demonstrate the hubris and arrogance of many of the fallen elite and to send a clarion call for future responsibility and accountability. There is no doubt that the failures of Fannie Mae and Freddie Mac which transformed them from “Government Sponsored Enterprises” into nationalized mortgage providers was a watershed event.

At the top of Fannie Mae was its CEO, Franklin Raines who presided over its explosive growth until he and his management team were swept out of office in December, 2004, due to an accounting fiasco. Without belaboring the sordid details, the facts and disgraceful result are as follows:

In 2006, Fannie Mae announced a restatement of their Financial Statements for 2001 through June 30, 2004 that

erased \$6.3 billion in previously reported profit. In May, 2006, Fannie paid a record \$400 million civil fine in a settlement with the Office of Federal Housing Enterprise Oversight (OFHEO).

**Raines' total compensation from 1998 through 2004 was \$91.1 million, including some \$52.6 million in bonuses.**

When the government sued Raines along with his CFO and controller in December 2006, they sought fines of approximately \$100 million and restitution totaling more than \$115 million in bonus money tied to the improper accounting scheme. Raines final settlement with the government included only \$1.8 million in cash, with the balance of \$22.9 million in then worthless stock options and "other benefits." **Fast forward. Fannie Mae is now in conservatorship with the Treasury committed to up to \$100 billion in additional capital. Franklin Raines walked with nearly \$90 million.**

As for accountability, after the announcement of the settlement, the best Raines could muster was, "While I long ago accepted managerial accountability for any errors committed by subordinates while I was CEO, it is a very different matter to suggest that I was legally culpable in any way. I was not. This settlement is not an acknowledgment of wrongdoing on my part, because I did not break any laws or rules while leading Fannie Mae. At most, this is an agreement to disagree." I'm sure the American taxpayers whole heartedly disagree.

**Main Street – Living Large on Plastic and the HELOC ATM**

While it is clear that Washington and Wall Street share substantial culpability for the sub-prime meltdown, Main Street doesn't escape unscathed. We all agree that the mortgage originators who generated obscene fees by offering 100+% financing with no income documentation and either

miniscule "teaser rates" or even negative amortization (increasing loan balance) loans were often preying on unsophisticated consumers.

Nonetheless, there is still some level of responsibility for those who simply rolled the dice, knowing that they could not make their payments when the rates reset two or three years hence. **Even the 95% of homeowners who pay their mortgages on time are likely part of the crowd that has run the nation's credit card debt to nearly \$1 trillion.** And, unlike previous generations that methodically paid off their homes and celebrated with a mortgage burning party, **today's "want it all, want it now" consumers have used their home equity as an ATM machine to live a bit larger.** The tab for Home Equity Lines of Credit has risen from \$163 billion in 1999 to \$1.2 trillion today. While amassing this mountain of debt, **Americans have now registered a negative savings rate, outspending their incomes, for the last three consecutive years.** Not since the "Great Depression" years of 1932-33 has there been a negative savings rate for a full calendar year. Blame Washington. Blame Wall Street. Check the mirror.

The restoration of the financial system will be protracted and painful for American taxpayers. As we travel the road back to economic stability we would do well to heed Mr. Santayana's advice rather than that of Kurt Vonnegut who, in response to the question, **"Have I learned from my mistakes?"** responded, **"Yes, I believe I could repeat them all exactly the same."**

**Grant/GrossMendelsohn, LLC**

36 South Charles Street, 18<sup>th</sup> Floor

Baltimore, MD 21201

Office: 410 685-9685

Facsimile: 410 752-1148

E-mail: Chris@GGMWealthAdvisors.com