

Reflections on the chronology of the financial crisis

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The financial crisis is not over but it has seemed less scary in the weeks since the US stock market decided that most big banks will survive. But before we get complacent, don't forget how far the market has gone down (basically it lost almost half its peak value) and how little the net bounce has been: year-to-date, the S&P 500 is still lower. That compares to +20% in Brazil, +25% in Venezuela, and +40% in Russia & China, just to pick out a few big winners.

Instead, some eye-opening numbers should remind everybody that the underlying problems are hardly resolved:

- mortgages securitized by Wall Street (in so-called "private label" mortgage-backed securities, MBS) represent 16% of all mortgages, but over 50% of seriously delinquent mortgages
- distressed sales accounted for a formidable 45% of all existing home sales
- average home prices are down 32% from their peak

Here's a current scorecard of this dismal game, which started in February 2007. We're still only in the top of the fifth inning (just before half-time of a European football match).

Who caused the meltdown and where they stand today?

1. Underlying borrowers were reckless.
Now they're preoccupied with surviving the recession. So those who can borrow don't want to, while those who want to often can't.
2. Loan originators (Countrywide, New Century Financial, GMAC, Household/HSBC, et al) and securitizers (Lehman, Merrill, Citi, Mgn Stanley, Bear) were complicit.
Now several of the big originators are either defunct, like New Century; merged, like Countrywide into BofA; or for sale, like Household. Same for the securitizers (fill in the blanks).
3. Ratings agencies were conflicted.
Now they are vindictive (and scared of being put out of business).
4. Buy side was lazy and cheap: lazy, because they didn't do their own due diligence on complex securities such as collateralized debt obligations; cheap, because they didn't hire objective experts to advise them. Instead like lemmings they followed the ratings over the cliff.
Now they're ashamed of how gullible they were and distrustful of Wall St.
5. Money was too easy and too readily available for too long.
Now it is appropriately easy but not readily available.
6. Everybody was taking on too much leverage.
Now everybody is trying to deleverage at the same time, which is impossible and makes the crisis drag on.
7. The Fed closed its eyes, while the SEC had given a nearly blank check to the entire investment banking industry to go to extremes.
Now they duck accountability while blaming all of the above.
8. Regulators were clueless in other ways (proven conclusively by the Madoff scandal) and politicians were living up to their reputations.

Now regulators aren't sure what role they should play: as tough enforcers or as genteel partners. And Congress is happy just to hold hearings and make people squirm.

After the financial meltdown came the Great Unraveling (the almost inevitable sequel to the ill-named Great Moderation), characterized by deleveraging.

The horrors of deleveraging

1. The sell side (meaning the main investment banks and investment banking divisions of big commercial banks, known in Europe as "universal banks"):

- didn't understand the MBS/CDOs any better than their customers and thus,
- believed their own sales pitches and bought too much of their own product, and
- didn't pay much attention to their sales contracts which often gave clients the right to put the securities back to them, and
- underestimated how fiercely those deceived buy side clients could and would strike back.

2. The Fed either

- misunderstood how the financial system was working or
- knew but decided to try to cover it all up. (The BofA chairman Ken Lewis's remarks to NY Attorney General Andrew Cuomo's interrogation that Paulson and Bernanke urged him not to disclose huge Merrill Lynch shareholders because they feared it would mutilate the whole system are instructive.)

Incidentally, the Fed's calling it just a liquidity crisis in the fall of 2007, at a time when CEOs were getting fired (Merrill's O'Neal, Citi's Prince, & others) was and is baffling. CEOs don't get fired for liquidity problems.

3. The global dimensions of what was unfolding were initially ignored. Then we had BNP Paribas restricting fund redemptions, IKB and Sachsen Landesbank failing in Germany, Northern Rock imploding in Britain, and even UBS getting scalded.

Policy responses

1. Fed went from

- providing liquidity
- to providing lender of last resort assistance (via the Term Auction Facility, TAF, essentially the anonymous discount window),
- to becoming intermediary of first resort (commercial paper financing facility, e.g.)
- to ending up creating the mother of all maturity mismatches through the mortgage-backed securities buying binge— which the Fed Chairman admits won't be unwound (actually it can be, but the losses that would probably be involved would shock even the Fed's most dependable apologists).

2. Treasury went from capitalist to socialist in three easy steps: marriage broker for Bear Stearns – JPMgn Chase, savior of Fannie and Freddie, rescuer of AIG -- and thus protector of the biggest derivatives counterparties through the TARP. [The execution of Lehman was a brief, ill-conceived diversion.]

What options are still on the table?

Geithner's latest gambit, call it Son of TARP, is announced but far from implemented: It is incredible the number of commentators, some very famous, who lump together the two totally separate programs he proposed. They are very different. One is sensible, the other is questionable:

1. The legacy loan program could work. We could call it the Return of Standard Credit Card Trust (the first successful securitization outside mortgages, developed by a troubled Citibank in 1988 in order to retain its profitable credit card business by securitizing credit card receivables. Since then every big bank has done the same.) What could make it work are these features: the FDIC's deep (for now) pockets to provide leverage; its willingness to do due diligence, so only the better loans get the full 6:1 leverage; auctions that could work because banks can withdraw if bidders bid too low; and, best of all, a fine objective, liquefying illiquid loans (forget whether they are "distressed" or not) that will improve capital ratios.

2. Legacy securities program is unlikely to be a big success. Once again it demonstrates the dangers of well-meaning, but hastily devised schemes. Why unlikely to be successful: Selecting a "Fab 5" of firms to buy and manage toxic securities, but with the taxpayer taking the vast majority of the economic risk was a recipe for taxpayer indignation. And it could have led to collusion among the "Fab 5". Treasury seems to have figured this out and now says it is prepared to take on more bond managers but the most likely Fab 5 candidates may in the meantime be getting cold feet. But prodding banks to sell securities and force **realized losses** – that is not going to be easy unless the US Treasury is intent on putting them out of business or forcing mergers with other institutions.

Some suggestions

Sensible ideas abound, not least by Lauren Tara LaCapra (not as famous Bill Gross or Peter Fisher, but she's been in the middle of toxicity for decades). Also U Chicago Finance Professor Luigi Zingales has published a number of widely-circulated, promising suggestions, too.

Unblocking markets in which buyers see huge downside risks that sellers don't is not easy. Somebody has to step in and provide options contracts that give sellers a clear upside potential if they are right (but have to sell to keep their government bail-out money) and somebody has to insure a portion of the downside risk so that the buyers will bid more for toxic, illiquid securities. That somebody is the taxpayer. But taxpayers have to be rewarded more generously than the Geithner plan.

The alternative is to buy time: keep delaying implementation of the legacy securities program, cross your fingers, and hope that the housing market stabilizes sooner than feared. When foreclosures stop climbing and then start to inch even a little lower, there will be a huge sigh of relief and the CDO market will gradually unfreeze. That's why the foreclosure prevention program tucked into the Obama stimulus package is still the most important ingredient. And why state and local governments deserve help in buying foreclosed properties before they are boarded up and spoil whole neighborhoods.

In the meantime, by all means implement the legacy loan program and help a lot of banks raise some sorely needed capital relatively cheaply. Also:

- Declare a temporary capital gains holiday for incremental purchases of equities, because without a sustained stock market rally, consumers have no alternative but to lift their savings rates. And that will prolong the recession, stunt the recovery, and maybe even trigger a "double-dip."
- Introduce competence exams for key board members of systemically important banks (at least the chairs of the three key board committees: audit, compensation, and risk evaluation). Newly hired 26 year olds have to pass pretty tough tests. How much more important is it for members of boards of directors to know the material cold?
- Scale back too big and/or too interconnected to fail institutions through divestitures.