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TRICK or TREAT: The Government Comes to the Rescue

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Background and Perspective

On Friday, October 3rd President Bush signed into law the Emergency Economic Stabilization Act (EESA), that is, the so-called financial rescue package. So what now? Depending on the government to “bailout” every ill-fated private business decision or homeowner dumb enough to purchase too much house is clearly the wrong approach; and, likewise offering total disdain for the appropriate role for government to step in a systemic crisis with actions intended to improve liquidity, exercise effective monetary policy and enhance prudential financial supervision is equaled misguided.

With that preamble, no piece of legislation signed by the President or single action by the Federal Reserve Board of Governors will cure what ails us. This global crisis has been years in the making and it will be years in the healing. These periods of turmoil and upheaval are ultimately constructive for the economy and its participants -- as once again we relearn the ancient adage …that all success is fleeting. Further, these periods of economic downturn, like competition or new technologies, are part of what Austrian economist, Joseph Schumpeter, termed “creative destruction” and they are essential for innovation and reassertion of capitalism. In turn, the downturns cause a reflective period, one of significant reevaluation by all participants in the market economy. But, over time Keynes’ “animal spirits” return and growth begins.

These recent legislative steps and administrative actions will slow the bleeding and assist the patient to make it to the hospital, but surgery is still needed. Throughout our history, America has faced similar and equally dire financial crises, including a famous one just 100 hundred years ago in 1907 which led to the formation in 1913 of an independent central bank, our current Federal Reserve System.

Panic of 1837
Source: Sandiego.edu

Panic of 1857
Source: The Bank of New York, Their Dealers, the Clearing House and the Panic of 1857; p.361

Panic of 1873
Source: Frank Leslie's Illustrated; October 4, 1873

Panic of 1893
Source: Brownstoner.com

Panic of 1907
Source: Jessie's Café American

Crash of 1929
Source: Presidentialtimeline.org

Not since the dark days of the autumn of 1929 have we faced such potential for global economic despair. Since those days, we have learned much about prudential regulation, role of low tax burdens, free trade, the importance of a robust monetary policy and the need to act promptly. And while these lessons have benefited the extraordinary creation of the most wealthy and successful economy in the history of man; they, nonetheless, today, face a major challenge. That is principally due to our subsequent tests to the lessons learned in the Great Depression have been in the form of *isolated* corporate failure (Chrysler, Long Term Capital Management, Drexel Burnham Lambert), or a relatively narrow but significant industry or geographic crisis whose cause and effect could be readily ascertained (New York City, Orange County, Mexico or even the savings and loan collapse). Today's crisis is global, complex and is affecting institutions of all sizes and missions.

<u>Today's Panic and its Origin</u>

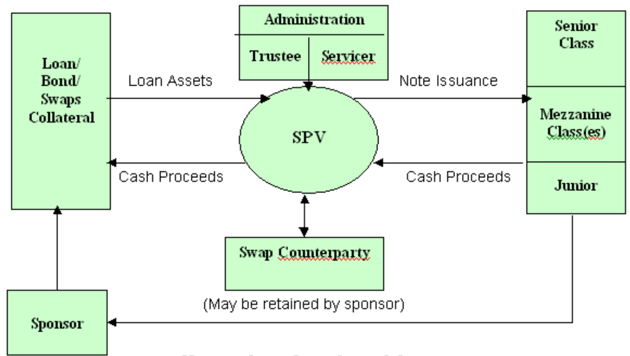
More alarming, today's vicious assault on capitalism comes from immense *self-inflected* wounds led by the lack of prudential risk management and inglorious and pervasive faith that computer models are more knowledgeable than common sense and the voice of experience. In other words, "Beware of 'geeks' bearing gifts!" And, by public policy errors in monetary and regulatory policy. Perhaps, the great political sage, Pogo, said it best: "we have met the enemy and he is us!" For the better part of thirty years in both my private and public lives in finance, I have seen the potential for this train wreck building and thus, I feel compelled to offer comment and prescription to learn from our mistakes and once and for all move forward toward a healthier economic foundation.

With the benefit of hindsight, one is able to see the ignition points. Individual investors were badly burned in the Tech Stock Crash of 2000 and turned to real estate as their "safer" investment choice de jure. The Federal Reserve cut rates dramatically to counter the Recession that began at the end of the Clinton Administration and continued to do so to counter the sharp economic decline following 9-11 – and monetary policy remained too accommodative for too long. These events began a nationwide increase in real estate investing. As these macroeconomic events were happening, market forces were reacting to two recent Congressional actions during the 1990's: first, increasing mandates – including pressure on Fannie Mae and Freddie Mac -- to increase home ownership for those at the bottom of the economic ladder and Congressional direction to prohibit regulatory oversight on certain derivative transactions – particularly credit default swaps (CDS). As a result, today's crisis has at its heart an out of control derivatives frenzy centered on a significant increase in real estate investment fueled by low rates and Congressional incentives.

Derivatives can be straight forward, such as being short or long a natural gas one year futures contract. But, many have been designed to have many variables and extended over a long contract life, say twenty years. Unless such a contract is secured some how with collateral or guaranty, then the terminal value depends on the credit worthiness of the two parties in transaction. This, of course, is a key problem, as a counterparty's credit is downgraded, then it has put up more collateral straining liquidity. Enron was famous for its esoteric derivative trading and you know the end of that movie. Warren Buffett and Charlie Munger, Chairman and Vice Chairman, respectively of Berkshire Hathaway, have been warning investors and the markets about derivatives, or "Financial Weapons of Mass Destruction"[1], since 2002. Buffett has described the derivatives quagmire as "…like Hell, they [derivative contracts] are easy to enter but impossible to exit."[2]

Congress and the Treasury have effectively agreed to acquire illiquid, complex derivative instruments from bank, insurance company and brokerage balance sheets. These acquisitions will be accomplished at some basis of market value. Therein lies the rub. What is market value? Many are arguing for elimination of the accounting rules (FAS 157) outlining how to establish mark-to-market value of an asset. Generally, I think this is a bad idea. Buffett calls tinkering with these basic accounting rules as "mark-to-myth."[3] Buffett himself has first hand knowledge of these struggles from Berkshire Hathaway's 2002 acquisition of global reinsurance giant, General Re. After ten months of winding down the operation of General Re's derivatives business following his purchase, the Company still had 14,382 contracts involving 672 counterparties around the globe and Berkshire loss millions.[4]

[1] Warren E. Buffett, *The Essays of Warren Buffett: Lessons for Corporate America*. Edited by Lawrence A. Cunningham. (Carolina Academic Press. Second Edition, 2008), page 145.
[2] Ibid., page 141.
[3] Ibid., page 142.
[4] Ibid., page 142.



Collateralized Debt Obligations
Source: Lehman Brothers

In my view, today's holders of Collateralized Debt Obligations (CDO's) or Collateralized Mortgage Obligations (CMO's) have, for the most part, written down much of this loss. Their capital will become more liquid and, in time, improved earnings will go toward building more capital and making new loans. In those instances where establishing value is more mysterious (that is, no one is offering to buy anything), then, in my view, one can live with a pool-by-pool analysis of actual cash flow from the underlying assets of the particular derivative contract and attempt to use a market capitalization rate to establish value. But, this work is hard and it will take time to value and unravel millions of individual derivative contracts – many of which have been packaged and repackaged and sold around the world. The core function of the Treasury and Federal Reserve plan is *speed this process up* and boost confidence by directly buying assets; placing more capital into the affected institutions, expanding federal deposit insurance coverage and forcing mergers of weaker banks with institutions that can provide a larger back stop. These efforts, in conjunction with European and Asian Central Banks and Finance Ministries, are intended to rapidly reduce the potential of a global systemic collapse of our banking system.

Compounding the negative global impact of hard to value and restructure derivative contracts is the financial innovation known as a credit default swap (CDS). Here a contract is agreed upon between two counterparties whereby one will pay the other if the debt of an issuer, that is the subject of the contract, fails to repay its debt as agreed. Thus, you have a massive derivative bet on some of the companies who were making massive derivative bets with asset backed securities composed of home loans, or bank trust preferred stock or the like. It is believed that this market alone has grown from some $2 trillion in 2002 to some astronomical number like $60 trillion recently.

The largest banks and investment banks in the world were engaged in this business that grew rapidly and profitably right under the noses of risk management committees and regulators. Their failures have caused problems for the rest of the economy including you and me. This folly has created a stock panic reducing the value of life's savings; it has caused the corporate commercial paper market, equipment financing market to seize up creating financing problems for companies; short term interest rates have had to be cut dramatically reducing earnings for those on fixed incomes. And, now comes the real trick – not a treat – the government is printing money in order to “solve” this myriad of challenges. We want Congressman Barney Frank (D-MA) and his friends out of our board rooms and back in the cloak room as soon as possible.

Given this complexity and massive impact, I believe the following areas of focus should guide policy makers as they debate future reform in the calm of upcoming days.

Actions in Response to Rebuild Foundation of Our Economy

Once a Nation has the Rule of Law, it must have a well-capitalized, diverse system of banks to insure the flow of blood of any economy -- capital -- to its highest and best use, principally measured by return on equity. Our Nation has been blessed by national bank charter standards beginning in the mid-19th century, the formation of the Federal Reserve as a central bank in the early 20th century and by a reform of our laws and rules governing securities issuers and brokers during the 1930's. In the post World War II world, we have experienced unparalleled prosperity. And, despite that generation of wealth creation and the earlier structural enhancements like a central bank, our country's bankers and regulators have retreated from planning for the downside of an economy and only assumed prosperity (a nice thought but never realistic – “can you say, Black Swan?”).

Now, that the rescue money has been assembled, policy makers need to work together and fill gaps in our prudential oversight of these product areas that have run amok.

Bank Charters…move away from too big to fail: Policymakers need to move away from the moral hazard of “Too Big to Fail”. Over the past few weeks, we have actually been teetering toward *increasing* future moral hazard by only exacerbating the Too Big to Fail notion. We need to recognize that commercial banks, thrifts and credit unions are granted a franchise charter and deposit insurance from the government. We need to increase minimum Capital Standards, not lower them. We need a more vigorous application exercise in order to obtain a bank charter. Let's take Atlanta, GA for example. As of June 30, 2008, of the total U.S. banking system, 21% of U.S. banks with Non Performing Assets greater than 6% of bank assets are in Georgia; 18% are in the Atlanta metro area; 9% are de novo institutions that is “start-up” banks.[5] While it is fundamental to preserve the entrepreneurial aspect of banking, that is, the right to succeed or fail, the taxpayers nonetheless are owed a rigorous process whereby deposit insurance coverage for a new charter is extended.

The mantra of the 1980's – 1990's that bigger is better is nonsense and certainly has increased the risk profile to our economy. The catalyst for this mantra was that European and Japanese universal banks would rule the world if we did not amend our rules and let our banks grow larger and offer universal banking services. And, naturally it is true as our American industries become larger and more global that they require banks that are larger and more sophisticated. But, in my view, we can achieve both policy ends.

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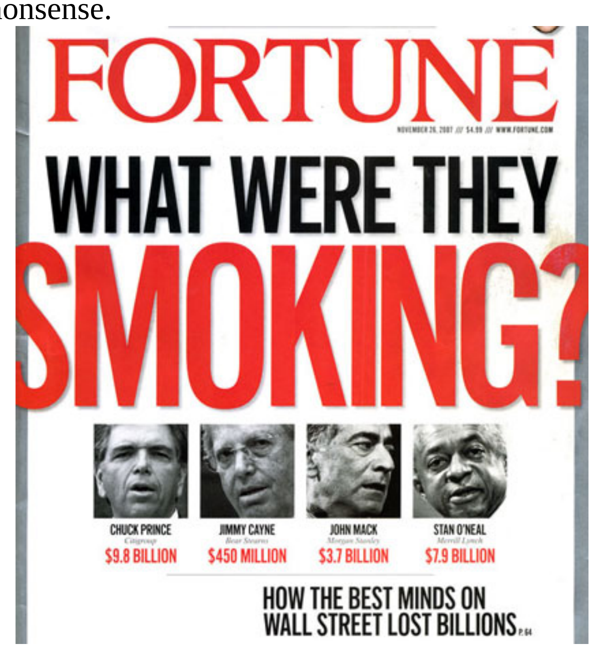
[5] Sheshunoff & Co. “M&A and Industry Update”. September 2008, page 21.

For the quarter ending in June 2008, those banks over $1 trillion in assets had tangible equity capital ratios of just over 4%. Four percent (4%) does not leave much margin for error. The balance of the industry had ratios in excess of 6% -- and, of that balance of the industry, ninety percent of the banks (those under $1 billion in assets) had tangible capital ratios in excess of 8%. Our country needs the diversity of a broad and deep banking system and we need to move away from building institutions on which our economy is too dependent and, as result, are too big to fail. Policymakers should consider easing the cap on total deposits *below* the current 10% and they should reconsider allowing only the very largest of banks controlling the very largest of our investment banking houses. It is not my intent to sound like a populist, I am simply arguing that competition is improved by more well capitalized players. In this regard, I believe that bank holding company ownership rules should be amended to encourage additional sources of capital. Large private equity investors should be able to invest in large banks or brokerage houses. Just as Warren Buffett's investments in GE and Goldman Sachs offer new ideas, new capital and new sense of ownership. So, too, private equity owners may well generate new ideas and competition. Some will decry my comments as heresy because they say returns in commercial banking are too low and thus that proves that we need bigger and bigger institutions. This is nonsense.



Source: Fortune Magazine, November 20, 2007

It is clear now that the CEO's of Lehman Brothers, Bear Stearns, and others had no idea of the massive systemic risk their firms were taking and my simple view is that our Nation's economy is not well served by a handful of gigantic corporations that are too big to fail.

<u>Disclose Off-Balance Sheet Risk</u>: Following the Enron debacle, corporate America got saddled with the extraordinary bureaucratic rules of Sarbanes-Oxley (not to mention the fact that an entire global accounting firm -- Arthur Anderson -- was systematically shut down for the errors of a few). But, apparently we learned nothing from the real culprit in the Enron disaster -- off balance sheet fraud and excessive derivative speculation. As I mentioned at the outset of these observations, the fundamental cause of our current

predicament is a toxic pile of computer-created, MBA-marketed derivative securities and structured finance vehicles. For me this has become the “Enronization of Global Finance.”

Congress lit the match on this derivatives explosion that led to some of Enron’s problems and now to the position where we find ourselves today. Congress specifically exempted Credit Default Swaps and other derivatives from regulation in the Commodity Futures Modernization Act of 2000 signed by President Clinton in December 2000. Congress needs to once and for all direct the Federal Reserve, the Commodities and Futures Trading Commission (CFTC) and the Securities & Exchange Commission (SEC) to find homes for proper disclosure and oversight of these instruments and critically, a clearing house for proper pricing and executing of the mountain of derivative related exposure in the world.

Source: The Wall Street Journal

Prudential rules can be considered such as setting a limit of capital to relation to levels of counterparty risk or requiring a reserve be set up by contract. Many traders were constructing derivatives with no equity, 100% leverage. Now wouldn’t you want to know the scope and scale of that book before you took the other side of insuring that trader’s company could make it’s own debt payments! In no sense will this be perceived as heavy handed or too much regulation, it will effectively be considered a badly needed road map for uniform standards. We have seen time and time again, uniform standards reduce uncertainty and improve spreads, thereby making markets more efficient. Further, uniform standards and a clearing mechanism will provide boards of directors a method whereby they can measure the risk that management is assuming. There are legitimate and productive uses for institutions to develop and use derivative products. Any proposed regulatory oversight should not throw the baby out with the bath water.

<u>Privatize Fannie and Freddie</u>: Since I was a young staffer on the U.S. Senate Banking Committee, some twenty-six years ago, Congress has added risky expansions of authority to these two government-sponsored enterprises to the point of August’s collapse. Every effort to curtail their outrageous lobbying expenses and ever greater executive compensation has been rebuffed. Every effort to limit their scope to only helping traditional lower income borrowers (who qualify on a prudent basis) through lower priced

mortgages has been rebuffed. Even one of their own, former Fannie CEO, the late A. Oakley Hunter, honestly described their daily funding requirements as the "biggest crap shoot in the market."[6] A former congressman, Hunter retired in 1981 with a modest pension of $80,000. In the 1980's the real fun started, imperial chief executive, David Maxwell, began the march of exceptional levels of compensation and lobbying expenses. Hunter said in a later interview that "executive compensation at Fannie Mae has run amok." [7] This was long before the outrageous – and still in dispute -- compensation packages afforded to Maxwell successor CEO's, Franklin Raines and Jim Johnson. Remember Fannie and Freddie are quasi-government corporations whose ability to make those huge profits were a function of their unique government attributes not available to any of their private sector competitors – yet Congress closed it eyes as did the boards of directors of Fannie and Freddie.

In their early existence, these companies created a liquid, secondary market for home loans and they set prudential standards for common underwriting, but much of that good has been lost by their poor corporate governance and sanctimonious lobbying, including their co-conspirators in defending their turf by the realty and mortgage banking industries. In the past decade, Fannie and Freddie have spent $200 million in lobbying the U.S. Congress. There is no way to put lipstick on this pig. This Congressional designed and implemented disaster doesn't make sense, and makes former Senator Bill Proxmire's (D-WI) proud attempts in the early 1980's to curtail Fannie Mae's power grab for commercial lending and CEO compensation look quaint.

The results of thirty years of inadequate Congressional oversight have exceeded even my wildest definitions of failure: over $50 billion in market value destroyed for common shareholders and wiped out $10-15 billion in preferred stock on the books of local banks; and a government takeover rivaling the entire GDP of all but a handful of countries in the world.

Once this immediate crisis is past, the Congress simply must exercise the will that it has failed to exhibit and create a safe transition of these monolithic federal orphans into private hands and insist that their charters return to setting prudent lending standards and helping people of modest incomes who financially qualify for a home – or better yet simply phase them out of existence. And, yes, for a time mortgage rates will move higher; but, there is no one to blame but the Congress of the United States.

<u>Reform Securities Laws and Corporate Governance Practices</u>: Like banks, brokers need to be subject to more prudential capital requirements. With leverage ratios of 30 to 1, there is no margin for error. Warren Buffett painfully learned this in his management of Salomon Brothers collapse due Salomon's unethical management 17 years ago. He said, "if you are dependent on borrowed money every day, you have to wake up in the morning hoping the world is thinking well of you".[8] SEC rules governing brokers' ability to raise capital need reform in order to better tie risk to level of capital required. For example, just last month, the SEC Inspector General reported that "only one-third" of

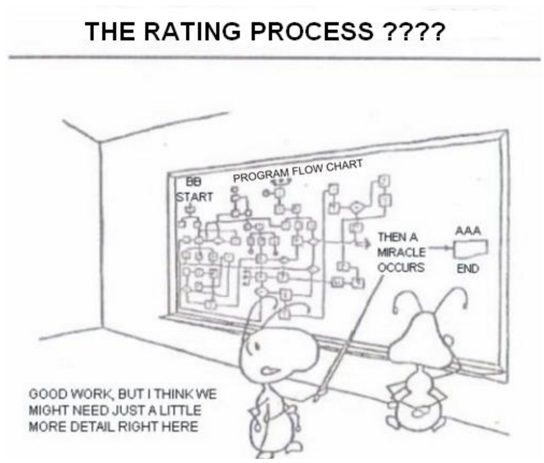
[6] J. French Hill, "U.S. Should Re-Evaluate Mortgage Role," *Dallas Morning News*, May 13, 1987.
[7] Sarah Anderson, John Cavanugh, Ralph Estes, "David Maxwell, Fannie Mae," United for a Fair Economy, September 1, 1999.
[8] Warren E. Buffett, comment at the annual meeting of shareholders, May 3, 2008.

the 146 brokerage firms required to report their risk assessments had done so…and further the Commission staff had only met with six of them.[9] This requirement was put in place following the collapse of Drexel Burnham Lambert in 1990. In recent weeks, we have witnessed the effective collapse of the independent investment banking and brokerage houses. Even the venerable Goldman Sachs is seeking federally insured deposits and the oversight of chartering as a bank holding company.

Banks and brokers engaged in financial services have a myriad of regulators: state insurance commissioners in all fifty states, the Federal Reserve, the FINRA (following the merger of the NASD and NYSE) for brokerage houses, the SEC, state securities commissioners in fifty states, the FDIC or Office of the Comptroller of the Currency (OCC) as federal bank regulator and fifty state bank regulators. And, believe it or not, there are some additional combinations. Members of Congress are considering a new approach to prudential supervision. We have not so since the Depression. Like the fresh look at our intelligence gathering and dissemination following September 11th, I believe the timing is right for such a comprehensive look. With our overlapping patchwork of regulators, such a move would be welcome by the financial industry.

There has been much talk about the "short sale rule." There is nothing inherently evil about selling a stock short. The evil has been the foolish changes in these rules made by the SEC. First, in July 2007, the Commission abolished the part of the rule that required a short sale occur only on an "uptick" in a company's stock price, e.g. so a stock in free fall could not be shorted. Next, the SEC has not enforced the required proof of the short seller who actually acquired borrowed shares (i.e. being "naked" the stock). There has been an "Uptick Rule" since the Depression reforms. Additionally, the market regulators should consider rules governing "short selling" company debt, now made universally available by the aforementioned Credit Default Swap (CDS) "industry."

Regarding consumer disclosure, the Commission should insist on greater transparency in the work of stock and bond Rating Agencies (Moody's, Standard & Poors and Fitch) and the standards for their work.



Source: Investmentpostcards.files.wordpress.com

[9] Sara Hansard, "SEC Criticized for Poor Oversight of Brokerage Firms," *Investment News*, October 13, 2008, page 29.

For example, set out in a rating disclosure that is available on the Internet and in the relevant prospectus or disclosure document as to how the rating was determined; who the senior analyst was on the rating; who paid for the rating and what price. Likewise, *caveat emptor*, buyers of securities should demand additional plain English disclosure enhancements in order to enhance and expedite their ability to independently ascertain credit quality.

Congress has a knee jerk solution to every problem in corporate America: Let's regulate chief executive officer compensation either directly or by way of limiting it's deductibility for tax purposes. Following the leveraged buy-out craze of the late 1980's, that was their principal solution. They are like the guy with a hammer -- the whole world looks like a nail. What we need is for shareholders in this country to wake up and demand quality from the boards of directors that are elected to oversee the company on behalf of owners. I hate to think in our successful system that the "Mommy Congress" has to set out rules for the private sector on how we pay management. Once again common sense has been lost. We have chief executive officers making tens of millions or in some cases hundreds of millions when they are terminated for failure. This is not for the government to correct. We need directors who are not just "independent" on paper, but are committed to truly representing the shareholders.

Concluding Thoughts

One must realize – and accept – that panics and crashes are the opposite side of the coin of economic growth and rebirth. No amount of computer prophecy or academic sophistication can dampen the hurricane of an overheated bubble market. There will be the inevitable reversion to the mean. The time for reform is now. The Congress has ignored much of what is locking up of markets today -- or worse and sadly, has been the architect of it. Pogo finally was right.

There will be future panics and they will have another cause, but the root cause will be taking on too much risk without properly assessing the return. We live in the greatest country in the world with the finest economic system. Those of us who represent shareholders as corporate directors and management must nurture and protect it for the essential system it is. And, let's demand the same of our elected officials.

J. French Hill is chief executive officer of Delta Trust & Banking Corp. in Little Rock, Arkansas. He was a senior economic policy official in the administration of President George H. W. Bush from 1989-1993 and was a staffer on the U.S. Senate Committee of Banking, Housing and Urban Affairs (1983-1984).

Arkansas Report Card

	Arkansas	USA
Unemployment	4.9%	6.1%
State Surplus	Yes- $300M	29 States Calling for budget shortfall in FY ’09
Bank Core Capital (6/30/08)	9.02%	7.58%
Bank Returns (6/30/08)	1.03%	0.52%
% Unprofitable Institutions (6/30/08)	5.00%	15.88%

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Arkansas Report Card Cont.

	Arkansas	USA
Subprime Home Loans 90+ Past Due/or Foreclosure Q II 2008	11.4%	17.9%
Prime Home Loans 90+ Past Due/or Foreclosure Q II 2008	2.7%	4.5%
Home Price Change LR/NLR (Q II ‘08 over Q I ‘08)	+0.8%	-7.6%
AR Existing Home Sales (Q II ‘08 over Q II ‘07)	-20.7%	-16.3%

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