An Economic Perspective

Ken Weiher
Chairman of the Department of Economics
Financial Meltdown

- Housing Bubble turns into a Full-Blown Financial Crisis
- Economy Slides into Recession
Sequence of Events

- Housing prices driven up by easy credit
- House prices peak; start to fall
- Foreclosures rise; prices fall faster
- Lenders in trouble
- Scramble for liquidity
- Lending shrinks
  - Money supply falls
  - Circulation rate (velocity) falls
Economy Takes A Hit

- Housing sales plunge
- Housing construction plunges
- High oil prices add to consumer misery
- Consumer spending slows
- Employment is down 760,000 this year
- Unemployment up to 6.1%
- On the edge of a recession
Familiar Territory? Reminds Many of Depression

- 1929 Stock Market Bubble worried Fed
- Fed tightened money to stop bubble
- Credit crunch and high interest rates
- Recession began
- Stock Market Crash in October 1929
- Bubble burst
Financial Crisis of 1930s

- Banks hard-up for liquidity (cash)
- Loans dry up
- Money supply falls
- Bank panics
- Banks fail
- All credit dries up
- Business spending halts
Government Response?
Make Matters Worse

- Fed lets thousands of banks fail
- Money supply plummets
- Fed fails to add liquidity to market
- Congress raises taxes
- Congress raises tariffs
- Depression becomes “Great Depression”
Government Response This Time

- Congress passes tax rebate
- Treasury and Fed add funds to market
  Lend funds to financial institutions
- Fed cuts Fed Funds rate 5.25% to 2.0%
- Congress passes “Bailout Bill”
- Everyone trying to avoid 1930s repeat
How Did All This Start?

- Let’s start with that housing bubble
A Simplified Overview of Mortgage Lending

Thomas A. Thomson
Professor of Finance and Real Estate
Director of Real Estate Finance and Development Program
The Old Days

- “Banks” made mortgage loans and held them in portfolio
- The interest paid on the mortgage was used to pay interest to depositors
- Banks charged more on mortgage than they paid to depositors (earned a spread)
- Twenty dollars down for every 80 dollars borrowed was common
- Borrowers submitted income tax returns to verify their last three years of earnings
Secondary Mortgage Market

- Banks originate mortgages and sell them to Wall Street then use the money from the sale to originate new loans.
- Now banks make a quick commission from originating and selling a loan, rather than from the long term holding and earning a spread.
- A mortgage pass through simply takes money sent in by borrowers and pays it to the pass through (bond) holders.
- The government or a quasi government agency would guarantee the income to the pass through holder in many cases e.g. Ginnie Mae’s.
Complexity ≠ Crisis

- Mortgages seemed to be very safe investments and had higher yields than government bonds.
- Many also had some sort of Government or private guarantees.
- Because many of the mortgages were guaranteed directly or indirectly by the government, these securities were highly rated.
- More investors wanted to buy bonds backed by mortgages.
Not Your Father’s Mortgage

- To expand the pool of mortgage borrowers the mortgages that were originated began to change.
- More loans with low down payments were accepted – some loans had no down payment at all
- Less documentation was required from the borrowers – rather than submitting income tax forms, a borrower could state their income (so called liar loans)
- Loans that required no pay down of principal were common (some even allowed a growing principal)
- Other loans had an artificially low initial rate or payment that would reset to a higher payment after 2 or 3 years
House Prices Were Rising

- When house prices rise rapidly, a borrower that runs in to trouble can sell the house at a profit and pay off the loan.
- As long as house prices went up, the new way of doing business worked well.
- In the last year, (July 2007 – July 2008) house prices in Las Vegas and Phoenix dropped by about 30%.
- A 20 city composite saw prices decline by about 16%.
- The overall two year decline is about 20%.
The Problem

- Many mortgages have now been made to “subprime” borrowers
- Many mortgages had no down payment
- Many mortgages were “liar loans”
- Many mortgages are having their payments reset to higher amounts that the borrower cannot afford
- The house cannot be sold for more than the mortgage balance; hence, an increase in the number of foreclosures
What About Those Mortgage Backed Securities?

- How much are the bonds worth that are supported by these mortgages?
- Not a simple determination as it depends on which slice of the cash flows a particular bond holder was promised
Role of Investment Banks?

John Wald
Associate Professor of Finance
Who Got Into Trouble?

- Investment banks
- Commercial banks (note that since 1999 these firms could also undertake some investment banking functions (Gramm-Leach-Bliley Act)
- Insurance Companies and others in the mortgage, CDO, and CDS markets
What Did They Invest In?

- Interest rate, Prepayment, and Credit Risks
- Mortgage Securities
  - CMOs (collateralized mortgage obligations)
- CDOs (collateralized debt obligations)
- Credit Default Swaps
  - Derivative contracts/insurance on other debt securities
  - Notional values of $45 to 62 trillion
Other Regulatory Changes

- “We have a good deal of comfort about the capital cushions at these firms at the moment.” — Christopher Cox, chairman of the Securities and Exchange Commission, March 11, 2008.
- 2004 SEC rule change allowing reduced capital for Investment banks
- Voluntary self-regulation
Recent Crises and the Lessons Not Learned

- S&L Crisis - late 1980s
  - Banks require tight supervision
  - Marking-to-market is probably a good idea
  - Firesales can depress asset values and bank capital
- Orange County Bankruptcy – 1994
  - You don’t have to be a Wall Street Billionaire to lose Billions
- LTCM – 1998
  - during a crisis risks become more correlated and liquidity risk is significant
Current Market Implications

- Spreads on risky assets increase
  - Commercial paper market
  - Corporate bond market
  - Existing derivatives
- Yields on safe assets plummet
U.S. Financial Crisis Plan: Bailout or Rescue?

Palani-Rajan Kadapakkam
Professor of Finance and
U.S. Global Investors, Inc. Fellow
March 2008 - Bear Stearns
Fed extends loan facility to investment banks. Previously, only commercial banks could borrow. In return, they were regulated.

July – August 2008: Fannie Mae/Freddie Mac assurances, temporary short-sale restrictions for major financial firms

September 2008
Fannie Mae and Freddie Mac – takeover
Lehman Bros. files for bankruptcy
AIG rescue
Short-sale restrictions for 799 firms – mostly financial
Financial Crisis Plan

- Credit markets seizing up
  - Banks not lending to each other – breakdown of financial system
  - Banks not lending to customers – contraction of economic activity

- Paulson Plan
  - Officially, Emergency Economic Stabilization Act of 2008 (451 pages)

- The purposes of this act are ....
  - (A) protects home values, college funds, retirement accounts, and life savings
  - (B) preserves homeownership and promotes jobs and economic growth
Key Elements of Plan

- Asset Purchases: $700 billion in phases to buy troubled mortgages and other assets
- Warrants, Equity Stakes
- Create insurance program for mortgage assets
- Other elements: foreclosure relief, executive compensation limits, provides oversight, restates SEC authority to suspend mark-to-market accounting
Mark-to-market accounting

- FASB Statement 157 requires that assets be carried on the balance sheet at ‘fair value’
  - *Level I assets*: readily observable market prices
  - *Level II assets*: no direct prices, but market prices can be estimated by observing trades for similar assets
  - *Level III assets*: use assumptions to come up with inputs for valuation models to estimate market prices
- Financial institutions have claimed that current market prices are ‘fire-sale’ prices and do not represent fair value; impairs their capital
- Merrill Lynch sold some of its mortgage assets for 22 cents on the dollar earlier this year
Will the Plan Work?

- Depends upon the nature of underlying problem

- "Banks need cash to make loans." Fed is willing to give loans

- "Panic sales of assets at greatly depressed prices will be avoided."

Whether the plan is a bailout or a rescue depends upon the prices at which the assets will be bought.

- "Transparency of asset valuations will restore confidence in banks."
Will the Plan Work?

- **Setting up auctions is problematic** because the underlying mortgages will vary from one mortgage pool to another. Depends upon the nature of underlying problem.

- **If auctions reveal low prices, more institutions will go under**
  Suspending mark-to-market accounting will just be a denial of reality.

- **Underlying problems:**
  
  **Housing bubble** – cannot directly resolve this; will help indirectly.

  **Extreme leverage of major financial institutions**: can be resolved only by equity injections.
Will the Plan Work?

- Global forces at work

US government has limited ability to tackle the crisis on a global scale

- Events are occurring at a torrential speed

A lot to be learned and digested for everyone including experts
U.S. Financial Crisis Plan: An International Perspective

Dr. Yiuman Tse
Professor of Finance and U.S. Global Investors, Inc. Fellow
Crisis?

- The U.S. dollar appreciated 8% against euro for the last two weeks
- No program of austerity
- No coordinated rescue by foreign countries
Where Does The Money Come From?

- $29 billion to back the assets of Bear Stearns
- $85 billion to buy the stocks AIG
- $200 billion pledged to swap Treasuries with investment banks
- $300 billion in discount-window credit auctioned to banks
- $620 billion “swap” line for European banks
- $700 billion bailout bill

Borrowing!

The U.S. government risks

- A debt explosion, and
- A sudden withdrawal of foreign financial investors

(Source: Financial Times, Sept. 28, 2008, Wolfgang Muchau, “Paulson’s Problem Presents Lessons for Us All”)

What can the Chinese and other central banks do for us?
Lessons from the Swedes

- The Swedish financial crisis in the early 1990s had similar origins to the American one.

- The bailout plans are different:
  a. The U.S. government buys toxic mortgage assets from banks, the Swedes took stock.
  b. The U.S. plan is indiscriminate.
     The Swedes only bailed out banks that would survive, offering guarantee for all creditors but not for shareholders.
Crisis?

- Yes. And international coordination is of the essence.
Main Street Issues

Lalatendu Misra
Chairman of the Department of Finance
U.S. Global Investors, Inc. Fellow in Finance
Concerns and Anger

- For the people who caused it
- For the resources that are being used
- For the long term impact on the economy

Banks are safe

- Do not panic!
- Higher FDIC protection
- 1 year CDs yield 4%+
Banks are credit constrained
- Construction lending
- Business credit lines
- Personal loan lines
- Car loans
- Keep lines of credit open

Business slowdown
- Construction, Small Business
- Retail
- Impact on jobs
Personal investing

- To withdraw from the stock market?
- To get into the stock market?
- Age, amount, risk propensity issues
- Retirement accounts

Take risks you are comfortable with

- Keep your jobs, Work a few extra years?
- Do not get credit spending get out of control
- Fixed rate mortgages
- Expenses you are comfortable with