

Truth and Consequences: Harsh Light on Responsibility in the Financial Crisis

By Hugh F. Kelly, CRE

A Google search of the terms “blame game” matched with “financial crisis” yielded 560,000 hits in early January 2009. *Business Week* (Oct. 18, 2008) was inclined to spread the guilt around, quoting Georgetown University professor Reena Aggarwarl that “it really was the whole system.” *Time* and CNN took a similar posture, posting a ‘dirty dozen’ list of villains on the Web as a New Year’s gift to the world. Those looking for more specific accountability – including the FBI and prosecutors – are not likely to be satisfied with such blanket appraisals. Commentators wanting to go public with particular candidates for malfeasance are more likely to pin responsibility on their favorite political scapegoats. Thus we have been hearing folks who are inclined to heavier levels of regulation piling on Alan Greenspan, especially in the wake of his sorrowful Congressional testimony in the aftermath. Those at the other end of the spectrum, meanwhile, hold up Fannie Mae and Freddie Mac as object lessons about what can go wrong when financial institutions become instruments of social policy.

Finger-pointing, per se, is not an especially helpful exercise. But it is useful to review the performance of those involved in the run-up to the Great Financial Panic of 2008 with an eye to learning lessons. As parents have been telling kids since time began, there is no disgrace in making a mistake as long as it enables you to do better next time.

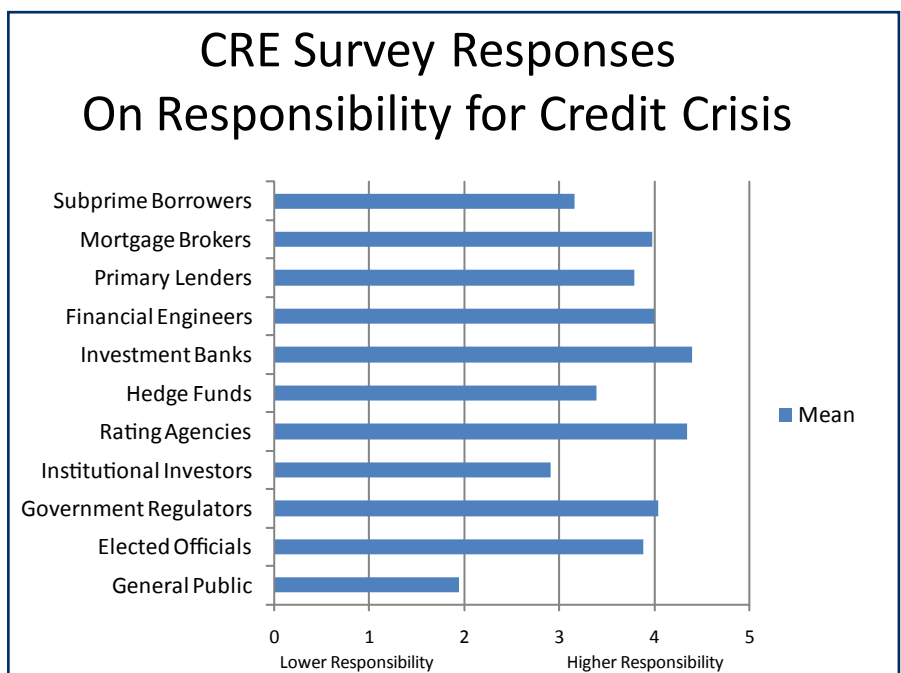
In order to get at the issues in preparation for a panel discussion at the Fall 2008 meetings of the Counselors of Real Estate (CREs), I took a poll of fellow CREs and asked them to evaluate the *relative* responsibility of various actors in this drama. By getting a fairly broad sample of individual judgments, I hoped to eliminate the politics and get at some of the core issues.

More than 130 CREs responded to my request, and rated 11 categories of ‘players’ on a scale of 1 to 5, where 1 represented the least level of responsibility for the

financial crisis, and 5 represented the greatest level of responsibility. Average scores are presented on the accompanying table.

According to their responses, investment banks and the rating agencies do not come off well at all. No wonder that such resentment was stirred when the takeover of Bear Stearns by JPMorgan Chase was orchestrated by the Treasury Department and the Federal Reserve. The press called this a “bailout,” although the initial price of \$2 a share and even the adjusted \$10 a share price paid by the bank was a paltry sum compared with the \$150 a share price Bear had traded at just a year earlier. The price paid for the whole firm was not much more than the value of its midtown Manhattan headquarters building.

The government’s intervention had some critics up in arms. Bear’s 35:1 leverage ratio was seen as the epitome of excessive risk. The packaging of fatally flawed subprime residential mortgages into complex collateralized debt obligations (CDOs), which the investment bankers brazenly peddled as “high-grade structured credit,” was perceived as modern financial snake oil salesmanship. The issue of “moral hazard” was prominently raised



Sources: Counselors of Real Estate, November 2008; compiled by Hugh F. Kelly.

by an interesting alliance of populists and laissez-faire market adherents. Any hints of a policy of “privatizing profits but socializing losses” was seen not only as a give-away to wealthy miscreants, but setting the stage for even worse risk-management behavior in the future.

Others noted that the structure crafted by the Federal Reserve and the Treasury to put the deal together had features that limited government losses and might actually return some money to the national coffers. Top management at the investment bank – and most of Bear’s employees – suffered grievous loss of personal wealth. And the cost of doing nothing – a total freeze-up of the financial system as institutions fled from counterparty risk – was seen even in the day or two after the transaction was first unveiled as a potentially catastrophic destabilizing of the entire financial system.

The financial markets themselves appeared to endorse the latter view. In the 6 weeks following the takeover by JPMorgan Chase, the Dow Jones Industrial Average gained more than 1,000 points, about 8.4 percent. The yield on 10-year treasuries moved from 3.3 percent to 3.8 percent over the same period, and continued upward to

4.25 percent by mid-June, a clear sign that the “flight to safety” that drove the market in early March had eased.

In September, we all got to see the results of whether this kind of “natural experiment” reasoning was correct. In a replay of the weekend crisis management that produced the takeover of Bear Stearns, government officials attempted to cobble together a rescue of Lehman Brothers by seeking some kind of similar deal. But ultimately these officials declined to put federal money to work in Lehman’s case, leery of its vast portfolio of credit default swaps and structured investment vehicles of dubious value and the 31:1 leverage ratio it had sported before getting an offshore capital infusion in August.

Those who called for the exercise of the “discipline of the market” back in March may have experienced a delicious moment of *schadenfreude* when Lehman declared bankruptcy. In retrospect, few are now convinced that this was a good case in which to test the “too big to fail” maxim. As we all know now, the Dow lost 34 percent of its value between September 14 and November 20, before rebounding into a trading range of roughly 8,000 to 9,000 in December and January. Treasury yields, meanwhile,



were driven down by an extreme flight to safety, with the shortest T-bill trading at what amounted to zero interest. This was the Panic of 2008, with multiple preparatory elements but the Lehman bankruptcy was the trigger.

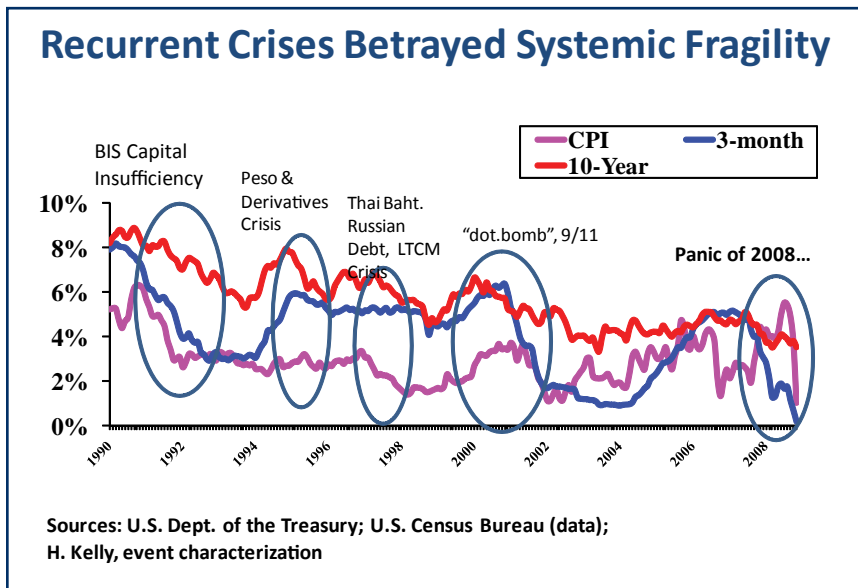
Within days, the Bank of America had acquired Merrill Lynch, AIG was provided with an \$85 billion credit facility by the Federal Reserve in exchange for a 79.9-percent equity stake, Goldman Sachs and Morgan Stanley converted to bank holding company status, and the White House proposed the \$700 billion Troubled Assets Relief Program (TARP). This cataclysmic week marked the culmination of a financial unraveling that had been emerging for more than a year, with roots that extended perhaps as long as decades.

mortgages.” That’s a tough position for investors when the payoff of the securities depends on the mortgages.

I see a couple of issues here, beyond the obvious ones. The first is that, in effect, the government outsourced a properly regulatory function to private, profit-driven firms when it designated a handful of firms as “Nationally Recognized Statistical Rating Organizations.” These are supposed to be overseen by the Securities and Exchange Commission (SEC), which has been largely toothless throughout the era of deregulation. So there was no real enforcement check on the rating agencies in exercising their delegated powers of capital rationing (for that is what ratings do in the multi-trillion dollar debt markets). Even worse, the capabilities of overseeing the continuous

innovation on Wall Street (now slowed, but only temporarily) may not be present in either the rating agencies or in the SEC itself. In a recent *New York Times* op-ed, Michael Lewis and David Einhorn cited the case of a whistle-blower who attempted, beginning in 2005, to lift the veil from the Bernard Madoff Ponzi scheme. His conclusion? The SEC enforcement chief tasked with investigating did not have “the derivatives or mathematical background to understand the violations.” The quants on Wall Street were way ahead of the monitors, as they were in the Long-Term Capital Management debacle – until, of course, events proved to outsmart them all.

The second issue worth considering is just how valid it might be for investors to shift the blame by the argument, “The rating agencies made me do it.” Investment managers, here



Risk was mispriced by the investment banks, and by investors generally, under conditions that have been termed “the Niagara of capital.” The rating agencies aided and abetted this mispricing, especially in the latter years, and these agencies join the investment banks at the top of the CREs’ list of responsible entities in the financial crisis. The “issuer pays” fee model presents a Prima facie conflict of interest, but one which could be managed with adequate due diligence and full disclosure. Unfortunately, neither of these attributes were brought to the forefront in the fast changing, high-stakes, and fiercely competitive world of structured finance. Highly complex CDOs were rated as though they were easy-to-understand corporate bonds, and statistical models were applied based upon an inadequate base of historical experience. As one Moody’s derivatives expert put it, “We check the math, not the

and abroad, are paid handsomely for the sophisticated handling of vast sums of capital. It is incredible that they would not look inside the package, but be satisfied with the ‘seal of approval’ affixed by Moody’s, S&P, or Fitch. At the very least, a greater understanding of the depth of the agencies’ due diligence and the quality of their models in evaluating as-yet-untested derivative instruments would seem to be among the investment managers’ fiduciary obligations. A review of the history of the past 18 years, presented in the historic graph above, reveals not only the recurrence of crises hinting at the increasing fragility of the financial system, but the frequency that troubles stem from relatively new forms of derivative investment. Did the investors not recall either that, as recently as 2002, the rating agencies (and the SEC) knew about Enron’s troubles months before its collapse, but maintained their

investment-grade evaluation of the company until 4 days before it went under? I suspect that investors may not be so forgiving this time, but who can tell?

Against this background, it is fairly easy to see why the CREs also put government regulators and elected officials in the upper tier of villains. Mortgage brokers and the financial engineers who crafted the toxic assets now poisoning the capital markets also were assigned high levels of responsibility, I believe for very sound, if all-too-obvious reasons. But the CREs responding seemed to see the institutional investors as more to be pitied than scorned. That, I think, may be charitable.

Interestingly, the subprime borrowers themselves were treated rather gently in the survey's results. In effect, the CREs saw, on the one hand, relatively unsophisticated subprime borrowers whose typical profile was a marginal-income household that suddenly had been given late entry into the housing boom. They were offered very low mortgage rates and sold a story as well as a house by mortgage brokers who knew but failed to point out the trap doors in the lending contract. On the other hand, there were the "big guys" at various points in the financial food chain who developed, sold, and packaged the instruments. They were paid royally for doing so. In assigning relative responsibility, then, "asymmetrical information" counts on both sides of the scale.

At the very bottom of the responsibility rank is the general public, according to the CRE respondents. I, however, am personally inclined to take a somewhat harsher view. There are a variety of aliases for the general public. The first is that they are also known as "the voters." If elected officials derive their mandate from the voters and, indeed the voters had time and again endorsed the policies of financial deregulation and government privatization that have dominated our politics since 1980, does not the general public need to shoulder some of the responsibility for the outcomes?

The other alias for the general public is "the taxpayers." And, in this guise, it is widely lamented that the public must bear the costs of the bailout and other systemic fixes that need to be put in place to reestablish the safety and soundness of the financial system and the functioning of the economy. But it was the opportunities for greater financial return, on both a before-tax but especially on an after-tax basis, that prompted the public to endorse the "get the government off the backs of industry" politics. Likewise, they cheered every new tax cut or every new opportunity occasioned by low interest rates. If over-leverage has toppled Wall Street, America's households

have hardly been more careful with credit of all forms. That we all must pay the price for our collective spree seems intuitively like "rough justice" to me.

All of this is painful, to be sure. The pain, in some ways, is just beginning. But as I mentioned at the start of this essay, we can draw some benefit if only it becomes a lesson that helps remedy future behavior. To take a step in this direction, I asked the CREs who joined me on the Credit Crisis panel last November to articulate "lessons learned" from this and earlier instances of financial market disruptions. Here, in somewhat Biblical form, are the guiding principles we thought it most important to offer.

10 Commandments for 21st Century Real Estate Finance

- I. Write upon thy heart the law that 'reward' and 'risk' shalt always appear in the same sentence.
- II. Make neither markets nor regulators into idols, and follow not false prophets of simplistic bias.
- III. Be sober and watchful, lest the enemy of massive loss approach like a thief in the night.
- IV. Honor thy father and thy mother's ancient counsel: Keep It Simple, Stupid!
- V. If thou wilt not do thy own credit analysis, then vow to invest not at all.
- VI. Thou shalt not adulterate thy portfolio with excessive leverage.
- VII. Thou shalt not bear the false witness of hidden assumptions in thy investment underwriting.
- VIII. Thou shalt not covet for the short term, yea, but shalt lay up thy treasures for length of days.
- IX. In all things, yield not to the tempter's snare of panic.
- X. Remember that, after thy exile in the wilderness, if thou heededst these commandments, thou shalt once again return to the land of milk and honey.

