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Introduction

By now, we have all heard of subprime mortgages and are learning daily of the widespread effects that a large number of non-performing mortgages and foreclosures in a weak housing market can have. Hundreds of billions of dollars of losses have been accounted for already. Many financial firms have already failed. Firms that have been venerable names on the investment and banking landscape for over a hundred years (such as Lehman Brothers) have been swept up and wiped out in the subprime fallout despite having survived world wars, stock market crashes and the Great Depression. The world's largest insurance company, AIG, last week was forced into the conservatorship of the government, exchanging 80% ownership in the company for a very suddenly needed bridge loan of around $80 billion. Just the month before, AIG was considered quite sound, profitable and secure, and then saw their fortunes change rapidly and shareholder value decline by 90%.

Only last summer I would have been hard pressed to find anyone outside of the financial industry who had ever heard of subprime mortgages. As house prices reached their peak over a year ago and the number of foreclosures began to edge higher we began to hear of this risk more and more with each passing day. I think it will be worthwhile to consider the series of events that contributed to our current worrisome state, and in so doing I will also lay blame – not for any unbecoming or unseemly reason, but because I think it will be useful in interpreting the blur of headlines and finger pointing and recriminations that fill the media today, and most importantly, so as to understand the complexity of this issue and how similar problems can be viewed or predicted in the future. I apologize that it will be a long read, however, trillion dollar problems can rarely be blamed on any one man or institution, nor can they be discussed in just a page or two.

How did we get here and who is to blame?

Ninety percent of all the information we are receiving on this mess is distributed through the mass media. I have my complaints with how the crisis is being explained and presented. In fact, the presentation may indeed be exacerbating the problem. This is no small concern given the vastness of the crisis and the many trillions of dollars involved, but it has very real, very personal consequences for a great many households around the world as it effects pension plans, employment, housing, taxes, and virtually all aspects of the economy. Yet, the sheer complexity of the crisis provides a ready excuse for the poor coverage. A journalism degree would not provide someone with the necessary background to fully understand this crisis. Understanding what brought us to our current state of affairs is important to understanding how we can move past it. Governments, bankers, Wall Street, Main Street, oil companies, China, Iraq, terrorists… dozens of players can all toss the blame back and forth at one another. But few problems of this magnitude have only a few to blame, and there is plenty of blame to go around on this one.

This crisis cannot simply be described as a failure of capitalism, or a function of greed or stupidity, or a failure of government policy or regulatory oversight. It is all those things. While we only just started hearing of subprime mortgages as they started to default in large number last year, they have been around for quite some time in the US. Going back to government policies as far back as the Carter Administration of the late 1970s, several laws have been enacted that have contributed to this crisis. Both the Carter and Clinton administrations passed laws whose intent, however nobly motivated, interfered with the free market for housing and loans. Policy goals included the rejuvenation of inner city neighbourhoods and a desire to increase affordability and home ownership rates among low and middle income families and visible minorities. Federally regulated deposit-taking institutions were given incentives or penalized, but the government goal was to increase the amount of lending to low income families and do so at favourable interest rates. For banks now required to issue mortgages that their previous prudent lending practices would not have allowed, the lending standards had to be changed. In 2003 George Bush championed the American Dream Downpayment Initiative to further aid low income families seeking home ownership. The net effect of such programs was to artificially increase demand for housing and inflate house prices beyond the true market level. Government policies in the 90s created the subprime mortgage, and started the inflation of the housing bubble. Some of the blame lies here. [1]

Financial institutions were required to take on some loans that were pretty risky. For Canadians, it has always seemed rather odd that people in the US were so heavily indebted to their mortgages (part of that is due to the tax deductibility of mortgage interest there – it makes sense to roll one's debt into a mortgage) and that no-money-down mortgages were so common. They were far less prevalent here. But the US financial industry bears a great deal of blame in all this. Many companies will fail, and deservedly so. In fact, in the Darwinian free markets, this will ultimately prove to be a useful and important process. Reckless risk-taking should always carry a price. The financial institutions that better managed their risks will come through this crisis stronger and better off for the failures of their less well-managed competitors. One of the wonderful features of a free and capitalist market is its ability to adapt and prosper from adversity. It is what financial companies attempted to do. Forced to take on a class of loans that were risky and unattractive, financial companies adapted. Their response was to begin to securitize this debt, meaning that they packaged up thousands of bad mortgages into a mortgage-backed security (MBS) and sold it off. Not only did this transfer the risk of a pile of bad mortgages away from them, it provided them an opportunity to make money on the transaction. The securities they packaged off received investment grade debt ratings from the major debt rating institutions (Standard and Poor's, Moody's, etc.). For clarity's sake – one junky mortgage is just junk. Ten thousand junky mortgages is a lot of junk. It is not gold. The ratings agencies have a great deal to answer for in this and will no doubt be the subject of much investigation in the years to come. Some of the blame lies with them.

For those financial institutions who came to be in the business of taking on bad loans, packaging them into investment grade securities and moving on to the next pile of bad loans…there is blame aplenty. As the housing market peaked and began to decline, many firms were left with packaged securities (piles of junky mortgages) that they could no longer sell. They were holding the hot potato and no one else wanted to take it from them anymore. It is

both a feature and flaw of the US financial institution that it is much more competitive than almost any other country. There are literally thousands of firms lending to home buyers, but only dozens here in Canada. The intense competition their market provides can be good for consumers. But it can also lead to such competition for mortgages that bad lending practices creep in – particularly during times of rising house prices – and many, many firms simply took on too many bad loans. Whether it be greed, ambition, irresponsibility or some other vice, the result was a lot of firms being saddled with non-performing loans and little to no equity securing their loans. The losses are staggering and make it easy to lay blame with the financial institutions in the US. The many failed firms and the heavy losses to shareholders of these firms are how markets assess blame.

The blame doesn't stop there. Central bankers (primarily Alan Greenspan years ago) are blamed for keeping interest rates too low for too long. This made mortgages cheaper, and homes more affordable – which only serves to inflate the price of homes since people can afford to bid more. I won't spend too much time on this one except to say that if we are to blame Greenspan's easy money policies in the late 90s and early part of this decade, then we will also have to blame the Y2K fantasists (remember them? The world didn't end at Y2K but they bear some blame for the financial world's current crisis too!) and the tech bubble's loud pop, and the terrorists of 9/11. All of these market influencing events contributed to Greenspan's efforts to stimulate the economy with low rates. In fact, the tech bubble's implosion has even more to do with all this since the falling stock market saw money pulled out of stocks and into real estate (more on that later). Currently, Chairman Bernanke is often blamed for not seeing the scope of the crisis soon enough and cutting rates, instead choosing to focus on the inflationary risks of this summer's commodity price spike. Where were the regulators while these risks were mounting? Government policy encouraged the risky lending that started all this, and financial institutions sought ever more creative ways of profiting from their ever increasingly risky loan portfolios. Yet there was nothing illegal in all this. Regulators were not given the task of enforcing prudence, and financial institutions failed to enact sufficient risk management. As the problem began to surface, it may be that regulatory bodies made matters worse as they enforced such policies as mark-to-market accounting. Stiffer regulations of the financial industry, often coming as a heavy-handed reaction to past crises such as Enron, may actually have hurt more than helped here.

Companies are required to show their assets and liabilities at the current market price. For example, if a package of mortgage backed securities used to trade at $1 for every $1 of face value in the market, then that is what a financial company showed on their balance sheet as their asset - $1. Last summer the marketplace for these types of securities very rapidly shrank as a few such securities were downgraded by ratings agencies. When there was no longer a thriving market for MBSs companies began to experience very real problems. Suppose the very weakest of financial companies, short on cash, decides to sell a MBS at what was then considered a fire sale price – say, 80 cents on the dollar. Since that transaction is now the only market price available, other institutions are required by accounting rules and regulators to carry all their similar assets at 80 cents on the dollar, resulting in massive writeoffs of their asset values. This meant losses to financial firms, an erosion of their capital and net worth, and started the chill in credit markets. After such a writeoff, perhaps a few more firms were pushed to the edge, and forced into a steeper discount in order to raise cash. If they sold assets at 60 cents on the dollar,

another round of writeoffs rippled through the industry. We have been witnessing this erosion of capital for months now. It is important to note, and I will discuss this in greater detail below, that these writeoffs may be required by accounting rules but it is not yet known whether the losses will turn out to be greater – or whether they will be substantially smaller. Time will tell.

Hedge funds and speculators have pushed and pulled markets around the world with increasing effect and caused tremendous volatility in the price of everything from stocks, to interest rates, to corn and oil. They have not been absent from the subprime scene. A week ago, the SEC (a regulator deserving of much scorn of late for being "asleep at the wheel") finally awoke. They announced that they would begin enforcing a rule that was already on the books against naked short selling. A short seller is someone who sells a security they do not yet own. They hope to sell it at today's high price and buy it back in the future at a lower price and thereby profit. Existing rules require them to have arranged to borrow the stock they are about to sell so that it may be delivered to the buyer. This only makes sense. However, the rule was rarely enforced, allowing short sellers to exert tremendous selling pressure on companies without the bother of finding stock to borrow, or paying a fee for having borrowed it. 'Bear raids' as they are called, were taking place with increasing regularity and ferocity in the past few months. Short sellers were able to drive the price of a company down, and in so doing make it more and more difficult for already weakened firms (sometimes weakened primarily by the mark-to-market accounting rules) to raise capital as their stock price dove. In the past two weeks we saw Lehman Bros. go into bankruptcy, but on the next business day Merrill Lynch shares were raided, pushing them into a marriage with Bank of America. As the ink dried on that deal, AIG shares were next in line for a raid, falling 30% the next day. AIG was forced into a deal with the government in order to survive. Once that deal was done, the next day Morgan Stanley was down 30% and Goldman Sachs down 20%. Each firm in this one week line of bear raids was stronger than the one before them, each one even further removed from the heart of the problems in subprime. Yet bear raids and unregulated speculation took their toll and the SEC was far too late to enter the game. And, in true ham-handed regulatory fashion, the SEC banned short selling in financial stocks until October 2nd – an unnecessary interference in the markets. Simply enforcing the existing rules, and perhaps bringing back the recently dropped rule that helped to curtail bear raids (the uptick rule) would have been sufficient.

My final category of blame recipients is one I hear very little of in the media discussions on this issue. But they are surely an important part in this: Individual home buyers. I think it is a sad departure from the past, and an unseemly feature of modern society that we have become a victim-culture and lost touch with the notion of personal responsibility. People are quick to sue, quick to evade responsibility, quick to claim the victim status and quick to turn to others for solutions to problems of their own making. North Americans still harbour the belief that real estate always does well, despite the evidence to the contrary. Even here in the GTA, the average price of a home in 1989 was just over $270000 – real estate fell in value and did not recover to this price until 2002 – 13 years later! The misconception that real estate always rises has created the belief I see so often among home buyers that it doesn't matter what they pay to buy. Since they believe real estate can only go up, they are confident they will be able to sell for more later, sell for more than they owe, and assume that their investment in real estate will generate a positive return. This is not always the case, and not in all time periods. It does matter how much you pay! Part of the reason the US is dealing with a subprime mess is that too many people

bought homes for too much money, and often couldn't afford it. We can, and likely will, spend years trying to apportion the blame among government, banks, Wall Street, regulators, realtors, speculators, and the like. But surely some of the blame belongs with those who bought foolishly and have defaulted on their obligations. For all the government policies, all the easy credit, I have yet to encounter anyone who was merely minding their own business one day and had Bank of America walk up and offer them hundreds of thousands in cash to go off in search of a home, or force someone to take out a mortgage. Individuals decided to enter the housing market, and in many cases did so unwisely. If "Main Street" is now going to pay a price for the fallout of subprime mortgages, they should also recognize that they are at least partly to blame.

What we have been experiencing is called a liquidity crisis. We have faced others in the past and markets and the world have moved onward and upward. Of particular interest I will revisit below the Savings and Loan Crisis (S&L Crisis) of 1989-91. A liquidity crisis could also be termed a period of tight credit. It's harder to get a loan. It isn't that you or your neighbour aren't a worthy risk, just that the bank doesn't want to lend any money out right now. Very simply, suppose you are a bank with $100 billion of assets in various forms (20B in cash, 60B in mortgages owed to you, 20B in office towers, etc.), and you have debts (deposits made by customers, bonds you've issued, etc.) of $80 billion. You have a net worth of $20 billion and you are in the business of lending out some of the money others have lent to you. Since you are required to have a certain amount of cash on hand at all times as a reserve to meet the daily demands of depositors – let's say this amount is $7B – you are concerned with liquidity (i.e. the amount of cash or securities you have readily at hand or on very short notice). Mortgages cannot be called in at will, nor office towers sold overnight to raise cash in a matter of days. Suppose that you find, in a very short period of time that your assets have declined by $10 billion, even though this was just the result of an accounting rule like mark to market. Would you be more or less likely to lend now that the liquid assets on hand have dropped by 77%, going from $13B to just $3B? Add to this the uncertainty of the future – what if you are required to take further writedowns? In an environment like this a bank may not lend to even very creditworthy customers, through no fault of the customers at all. Mortgages are not written, so houses stop changing hands. Inventories are not financed so factories cannot build. Cars are not bought since loans aren't available. This is the fearful potential of a liquidity crisis. Mark to market accounting rules are inflexible and not helping the current situation, where the market for many assets has stopped functioning. What is to be done?

The "Bailout"

On September 17th, Treasury Secretary Henry Paulson and Federal Reserve Bank Chairman Ben Bernanke went to Congressional leaders with their plan to "bailout Wall Street". I think the term bailout may be less than constructive. The Troubled Asset Relief Program (TARP) is intended to provide liquidity to financial firms; to 'unfreeze' credit markets; to provide a market for financial instruments whose market has ceased to function properly. Financial institutions around the globe have already written off hundreds of billions of dollars in MBSs. A significant portion of these losses are required by accounting rules and have not yet been realized. Only after a foreclosed home is sold can we be sure of the extent of the loss on that mortgage – in the meantime, accounting rules require the bank to write off a portion of the mortgage even if it is not yet foreclosed, but is just behind in payments. Financial institutions

carry hundreds of billions of dollars of difficult-to-price assets on their books and these assets have become illiquid – they cannot be easily converted to cash at anything but fire sale prices – and this is a problem because if I want a loan for a car the bank cannot give me a MBS to pay for the car. They need cash to issue me the loan.

TARP will mean the appropriation of perhaps $700B by the US government to purchase and provide a market for the distressed and illiquid assets held by lending institutions. This is NOT a $700B aid package. It is not a gift. It is not even a loan to the banks. The government will purchase $700B worth of assets with their $700B of borrowed money. The net worth effect to the government at that moment – zero. 700 more in debt but 700 more in assets. For the banks, they will transfer illiquid assets of approximately $700B in value to TARP in exchange for $700B in cash – liquid cash that can return the banks to the business of banking and lending to worthy borrowers. The net gain to the bank on that day – zero.

I am a supporter of the TARP plan, as are many more notable and eminent people such as Warren Buffett. The greatest fear I have had in this whole mess, which I believe has been allowed to linger and fester and decline far more than was necessary has been on the political front. We are in the final turn of an election race. The Democratic Congress, I believe, considers the economic mess they blame on Bush and the Republicans to be a bonus for their electoral aspirations and that of their candidate, Barack Obama. As I've discussed above, there is a long, complicated and substantial amount of blame to go around, every bit as much deserved by Democrats and Republicans, by Clinton and by Bush. But politics can be at odds to the requirements of the economy and markets. Were this not an election year, I think we would have seen earlier and more decisive action – essentially, I think we would have seen TARP, but at an earlier time where it could have saved much of the damage of the past few months. It was only the inescapable necessity of the current liquidity crisis that has made it obvious that this is not an issue that can wait for November or for the next administration. Still, even as I write this, Republicans (the minority party in Congress) have begun to dither. Ever the opportunists, these politicians now see a chance to leave the passage of the legislation to the Democrats while they stand at the sidelines and lob criticism – this way they can always say in the future that any problems with the plan were the fault of Democrats, but still lay claim to any success since it is a Republican administration. This is most unfortunate. We need less politics and more good government. Markets do not care for inactivity or uncertainty. I think the toll that politics has taken on the markets has been severe and has meant declines in stock markets that we needn't have seen to this degree. I will breathe a sigh of relief when Congress sets aside their partisan disputes and does what must be done. I think markets will too.

The media has been full of recriminations and bluster of late. We hear that Wall St. and rich bankers are going to be rescued from the losses their own greed brought about. We hear that the humble taxpayer is once again getting the short end of the stick and will be stuck with a $700B tab, while rich brokers get a handout from government. The costs (and benefits) of TARP must be considered in comparison to the costs of not instituting the program at all (and the idea of doing nothing at all has much popular support), but we must also consider it with a deeper understanding of how it will work than the media seems interested in exploring. One of the challenges facing TARP will be how to value the many, often complex financial instruments they will now be offering to buy. But they are buying assets, not doling out alms. The financial

companies have already accepted and booked losses on these assets. That is, the $700B of assets probably represents loans that were issued for much more and were once valued well over $1 trillion. The government will be buying these assets at already deeply discounted prices. TARP will take on the assets and dispose of them over the course of years in a slow, purposeful and orderly fashion. I believe the goal of TARP should be to break even. If they don't pay enough for the assets, then banks will have less liquidity available and the economy will be unnecessarily slowed. If they pay too much then the banks will be unnecessarily enriched in that they will receive more than a fair market price for their assets, and taxpayers will have to sell the assets at a loss. If TARP takes in $700B and sells the assets for $700B the effect to taxpayers is zero. Even if they end up losing, say, $200B, then I believe it will be a fraction of the losses the economy and government revenues would suffer without the program. Consider also that the total value of residential housing in the US stands at well above $20 Trillion. Suppose the effect of the plan were merely to stabilize falling house prices. If TARP ended up costing $200B, but supported real estate prices to the tune of just 1%, then the net effect on wealth in the US would be zero. Warren Buffett has earned his reputation as a savvy investor. Depending on your view of the media, you might be surprised – or not surprised – that his comments earlier this week did not get more attention. Speaking on CNBC he not only supported TARP, he said that he thought taxpayers would make money with it; that it would cost less than the program would eventually generate as it buys assets at distressed prices and later sells them for more. Warren Buffett: **"It should be a lead pipe cinch to make 10 percent at the type of prices that exist now," Buffett said. "The government is getting $700 billion of assets at what I regard as attractive prices. . . . If I could borrow $700 billion at the government's terms, I'd be doing this."** To me, that should have been a headline.

We hear daily about a false distinction. This is not as simple a plan as to say that taxpayers or Washington is bailing out Wall St. or bankers. This will not likely be the case. But, we live in a society where the average household is a homeowner, a mortgage debtor, an employee or business owner, perhaps a pension plan member, and likely, an investor all at once. The TARP plan may well be the least expensive option before us in all our many roles. Homeowners may see a stabilized housing market. Mortgagors, lower mortgage rates. A stronger economy benefits employees and owners alike. Pension plans and investment portfolios will benefit from all of the above, but mostly from the removal of the liquidity crisis and the uncertainty so badly crowding markets now. Government tax revenues are hurt by failing companies, higher unemployment and slowing economies – if TARP can help stave off a decline in tax revenues it may end up being less costly than inactivity.

To call the current liquidity crisis a logjam is a great metaphor. Logging companies used the cheap transportation of rivers to float their products downstream closer to their markets. Occasionally, the logs would cease to flow – they'd get all tangled up and jammed in some bottleneck. The best way to clear a logjam? Dynamite. A big bang of a solution to clear the logjam would do the trick and I think TARP is just the kind of dynamite the financial logjam needs now.

History as a guide to the future

As is so often the case, we ignore history at our peril. The not-so-distant past provides us with an instructive example of a problem just like the one we now face. The S&L crisis was a very close parallel to what we are now witnessing. In 1987, the stock market crashed, registering its worst day in history. As is typical in stock market declines, interest rates were cut to help stimulate the economy and provide liquidity to markets. As is also typical, frightened investors withdrew money from the stock market. Stock markets and the real estate market tend to be negatively correlated. When money came out of stocks, particularly with lower interest rates available, much of it went to real estate. The few years at the end of the 80s were the best for real estate prices. As real estate soared higher, aggressive lending to buyers who no longer seemed to care about how much they paid for a home helped inflate a bubble. Prices corrected sharply. Throw into this mix a sharp spike in the price of oil as Saddam invaded Kuwait. Fear of inflation and the uncertainty of a looming war in the Gulf brought further pain in 1990. The economy suffered a recession worse than any we've seen since. The party was over and the thousands of financial institutions who had loaned aggressively to people who could not afford the prices they were paying now found themselves facing a tide of defaults and foreclosures. A liquidity crisis took hold, exacerbating the decline in house prices and the economic slide. Congress created Resolution Trust Corp (RTC) as a clearing house for the failing assets and failing financial institutions. In all, many hundreds of S&Ls failed. Yet the cost to taxpayers for RTC, when it finally completed its task and was wound down a few years later was much smaller than had been feared. The reaction of governments and central banks then, as now and with other liquidity crises, was to inject hundreds of billions in liquidity into markets. This money remains in the economy for the years that follow, and is magnified in effect as it moves throughout the economy. I believe that the outperformance of stocks through the 90s was in large part a result of the S&L crisis bailout.

More recently, after a stock market collapse at the start of this decade, we saw much lower interest rates and money leaving the stock market in favour of real estate. The few years following the stock market collapse were the best in a generation for real estate prices – except for the few years of the late 80s – and the whole cycle repeated itself. Indiscriminate buying on the part of individuals, aggressive lending practices based in part on the belief that real estate will rise endlessly to offset the risky loans, the inevitable correction to real estate prices, the rise of defaults and foreclosures, the liquidity crisis this creates and, finally, today, Congress considering an RTC-like rescue package. To make the parallels all the more complete, we even had a Gulf War and a huge spike in oil prices to stoke the inflationary fears. Heck, even the president's name is the same!

As the S&L crisis unfolded, stock markets panicked. From January of 1990 to October of 1990, the US market declined approximately 22%. This time, we are down 23.5% as I write. *Most importantly*, what was the market reaction following the scary decline in stock prices in 1990, in the midst of the S&L crisis, with high oil prices, an economy limping through recession, far higher unemployment than we have now, and war on the horizon? Before answering, keep in mind that stock markets are always anticipatory, and almost as often, manic-depressive in that the go too high in good times and too low in bad times. **From October 1990 to October 1991, the US stock market rose 34%!** The five year return to October of 1995 was 100%. If history

is any guide it shows us that stock markets anticipate the future and begin to price in the resolution of a crisis long before the crisis has left the headlines. It also shows that buying opportunities exist at the point where the headlines are their most hysterical.

Conclusion

We now face a complicated problem that was long in the making. Many, many players share in the blame for it, and many, many of those players will suffer losses as a result. One hopes that they will suffer in proportion to their role when all is said and done years from now. I think it is unfortunate that politics would seem to have made matters worse this summer than they needed to be. The volatile stock markets that are a feature of our modern, technologically advanced world, and the ubiquitous media round-the-clock saturation of the issue have only made matters worse. For long term investors, history perhaps provides some comfort that we will indeed get past all this. But for those whose investment discipline is shaken by the volatility and withering stream of headlines, I sympathize, but fear that history will repeat itself and once again be unkind to them.

- Alan Cameron
  September 26, 2008

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[1] For a brief discussion of the role of policy makers and regulators, see this February article: http://www.nypost.com/seven/02052008/postopinion/opedcolumnists/the_real_scandal_243911.htm?page=0