Tea Leaf

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Your guide to understanding today's economy and financial markets

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Blame Game

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Where to start…knowing that whatever is written today will be largely outdated by the end of the week!

First Item: I would strongly suggest that the $700 billion ***financial rescue package*** would have passed in the House of Representatives on Monday IF the Congress and the national media had used that description of the program. The adopted terminology of calling it a Wall Street ***bailout program*** upset millions of taxpayers and made it much more difficult for many members of the House facing tough re-election campaigns to vote for it.

The program was, and is, designed to help restore some level of sanity and fluidity to domestic and global credit markets, which are traumatized by a major lack of confidence. Credit markets have frozen up, with painful consequences for businesses and working people across the country if some stabilization plan is not soon enacted.

Second Item: There is nothing magical about the current financial rescue package. A program involving greater participation by the FDIC to strengthen commercial banks also has merit. Don't be surprised in coming days if the FDIC increases its insurance limit from $100,000 per insured account to some higher level. Such a move would be very beneficial.

Some variation of the program the Swedish government used in the early 1990s to solve a similar housing-induced banking crisis also has merit, although time is of the essence. The Swedes took bad loans off the books of banks in exchange for some ownership of those same institutions, and ultimately returned a large share of funds to taxpayers when market conditions improved.

What is critical is for the Congress to do *something* to change the incredibly negative mood within domestic and global credit markets and help restore the needed flow of funds among and between financial institutions and their customers.

Third Item: Many members of the Congressional leadership in both parties, as well as dozens of long-time members of Congress now trying to develop a strategy to deal with the financial crisis, were the same people who accepted substantial campaign contributions from lobbyists of Fannie Mae, Freddie Mac, and Countrywide Financial Corporation among others, partly in exchange for keeping regulators off their respective corporate backs in recent years. The holier-than-thou attitude of many Congressional members is quite appalling.

Fourth Item: The national media's constant fear mongering about the financial crisis has only made the situation worse. As noted above, constantly referring to the proposed Congressional rescue package as a *bailout* program led to its demise on Monday.

The lead story in Monday's USA TODAY *Money* section discussed the fact that 33% of recently surveyed Americans thought the U.S. was currently in a Depression. Two accompanying pictures showed a "bank run" in August 1931 (hundreds of people congregating outside of a distressed commercial bank desperate to get their money out).

The other picture was dated July 2008 and showed a long line of people lined up to presumably get their money out of failed IndyMac Bank in Pasadena, CA on July 14, after it reopened under FDIC management. That, in my opinion is poor journalism, and only pushes depositor fears to even higher levels.

CNBC-TV constantly flashes "Is Your Money Safe?" and "Wall Street Crisis" on their screen, in my view further fanning the flames of viewer anxiety. The phrase "bad news sells newspapers" and its current media variations only make the current financial situation worse.

(We first ran the discussion on the following page on April 16, 2008. It is still relevant today.)

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An Accident Waiting…

No shortage of ink has been used during the past year to dissect the root cause of the housing crisis that grips too many American communities…

…some focus on the idea that home prices simply went too far too fast in too many markets during 2002 to 2006, thus requiring the inevitable and painful downward move in home values

…others focus on the fact that numerous Wall Street firms got too involved in slicing and dicing mortgage-backed securities into tranches (pieces) to be bought by aggressive investors around the nation and around the world

Many of these mortgage lenders were not really concerned about loan quality because the loans were made to be sold. It was all about quantity, and little about quality

…others take Wall Street firms to task for creating a myriad of securities based on complex mathematical relationships to help investors (in theory) offset risk in volatile financial markets. Such exotic securities ultimately worked very poorly (in many cases) as financial markets went through emotional gyrations unimagined by math geeks and their computer models

…others criticize credit rating agencies such as Moody's, Standard & Poor, and Fitch for their eagerness to put Aaa/AAA ratings on subprime mortgage securities that were logically dubious in quality…. but generated attractive fee income for the rating agencies

…others take the Federal Reserve and other regulators to task for their being asleep at the switch as various "accidents waiting to happen" in the lending sector were in their formative stages

…still others take the Congress to task for their pressuring financial institutions to be more creative and more aggressive in helping people in less-advantaged communities, and/or with lesser abilities to qualify for mortgage loans, to be able to have the American dream…owning their own home

The Lender's Incentive

One other factor is clearly at play which doesn't tend to get much attention

…it involves the element of lender incentives

The traditional relationship of a mortgage lender and a customer was quite straightforward. A customer needed to demonstrate stable income and the ability to repay a loan.

The lending person was traditionally compensated via the *Quality* of loans. A lender was "responsible" for (and compensated for) the performance of loans in his or her portfolio.

In recent years, a boatload of new lenders appeared on the scene, many of which specialized in subprime lending, or providing loans to people with less than glistening credit. These lending people were compensated on the *Quantity* of loans made…the more the merrier.

Some of these mortgage lenders encouraged their customers to borrow more money than perhaps needed, to over estimate their incomes and ability to repay in many cases, to actually avoid income documentation in many cases, to seek the loftiest appraisals on properties, and at times to make false statements in complex loan documents.

Many of these mortgage lenders were not really concerned about loan quality because the loans were made to be sold. It was all about quantity, and little about quality.

My favorite definition of economics is "people respond to incentives." In this case, lender incentives were simply creating another accident waiting to happen.

Jeff

"TEA"ser

Democratic VP candidate Joe Biden made the following comments a few days ago about what we might gain from the past about the current financial crisis…

"When the stock market crashed (in 1929), Franklin D. Roosevelt got on the television and didn't just talk about the, you know, the princes of greed." *(Chicago Tribune)*

…just two problems with those comments…can you identify them?

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