

DENVER  
**BUSINESS  
JOURNAL**

VOL. 60 NO. 24 November 28, 2008-December 4, 2008 32 PAGES \$2.00

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**Everyone  
shares blame  
for our  
economic  
downturn**



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**T**he blame game for the bad economy and credit meltdown has been endless, particularly during the recent political season (thank goodness it's over). Is it the "failure of free market capitalism" as the left suggests, or "social engineering gone bad" as some on the right offer?

Though President George W. Bush, Federal Reserve Chairman Ben Bernanke and Wall Street often are blamed for the difficult shape we're in, the culprits are many. They include:

- **Americans living beyond their means** — Since 1990, outstanding home mortgage debt has grown from 69 percent of disposal personal income to 100 percent today. Consumers withdrew equity from their homes, bought homes with 100 percent financing and financed multiple properties.

Since the middle 1990s, economists have warned us about the steady debt accumulation by both households and financial institutions. Between 1977 and 2007, U.S. debt rose from 1.6 times gross domestic product (GDP) to 3.5 times. Now with home prices plunging and loans harder to obtain, consumers are saddled with massive amounts of debt and real estate that can be sold only at fire sale prices.

- **Politics and government** — The roots of privately owned, government-sponsored enterprises go back to the Great Depression, when President Franklin Roosevelt established Fannie Mae to facilitate liquidity among lending institutions.

In 1999, the momentum for subprime mortgage lending exploded when Fannie Mae eased requirements after years of pressure to breathe life into the Community Retirement Act. Signed into law by President Carter in 1977, the act was designed to encourage banks to lend to low-income communities.

In 1999, Franklin Raines, CEO of Fannie Mae, said, "There remain too many borrowers whose credit is a notch below what our underwriting has required."

As a result, Fannie Mae became the significant issuer of subprime mortgages, and rewarded politicians and lobbyists with handsome amounts to keep away the regulators. These actions led to a complete breakdown of standards in home loan organization and securitization.

- **The Federal Reserve's key role** — In 2003 and 2004, the Fed pushed short-term rates down to 1 percent, creating an incentive for individuals and institutions to take on more debt. Homebuyers succumbed to super-low teaser rates, adjustable rate mortgages and interest-only loans. Borrowers either ignored or didn't understand that rates had only one way to go — up.

Further, there were enormous incentives on Wall Street to leverage financial products at these low rates. Excessive risk-taking by Wall Street banks with Main Street deposits exploded, which was made possible by the repeal of the Glass-Steagall Act in 1999.

Wall Street hedge funds, rating agencies and academia earned gigantic fees in developing collateralized debt obligations (CDOs) from many types of debt — mortgage, credit card, automobile and corporate. Pools of debt were

sliced into classes and then often "insured" through a credit default swap by an insurer (such as AIG) without any capital adequacy guidelines.

Today, these "structured" products are valued in the trillions. Somewhere buried in the products is an obligation to pay interest and principal on this underlying debt.

Rating agencies such as Moody's and Standard & Poor's were eager to earn large fees for rating these structured products. Initially rated as AAA, the same rating as a U.S. Treasury, CDOs are priced today at 50 cents or less on the dollar. These AAA ratings enabled Wall Street to aggressively gobble up the products and peddle them to their customers. Investment banks and hedge funds used leverage in acquiring these assets.

As yield spreads narrowed over safer investments, hedge funds employed even more leverage to force returns higher and maintain the level of fees.

As markets faltered, the failure of one financial firm had widespread repercussions on other firms due to their complex and intertwined relationships. Margin calls forced massive deleveraging.

Ultimately the buyers of these products were too few, and those rare buyers were offering only pennies on the dollar. Consequently, more liquid stocks, commodities and credit instruments were aggressively sold, and the markets collapsed.

- **Not enough, or too much, regulation** — As mentioned earlier, the Community Reinvestment Act and the repeal of the Glass-Steagall safeguards had major roles in the credit debacle. However, these regulatory changes were only the beginning.

The Public Company Accounting Reform and Investor Protection Act of 2002 (aka Sarbanes Oxley), required CDOs, whole loans and mortgages held by these institutions to be "marked to market." Because there have been few buyers, the pricing of these products has been crushed.

In the case of mortgages, most were still performing and collateralized by a home. However, recent market prices of many mortgages were far less than the value of the housing collateral, which is unusual.

Therefore, the holders of mortgage securities were forced to reflect prices that are unrealistically low, triggering margin calls and debt downgrades by lenders and brokers.

In addition, bank regulators suddenly have awakened, becoming much more strict. Credit requirements have been raised at a time when the economy is receding, and in need of liquidity and loosened regulations.

Mortgage regulations failed to stop predatory lending as the mortgage originators and the lenders often were disconnected. There's evidence that not only did mortgage applicants lie on their applications, but at times they were encouraged to, in the race to get a deal done and earn a commission. Lenders often sold these mortgages, which further distanced the relationship between the originator and the mortgage holder.