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ABSTRACT

In October 2008 the Southern Utah University School of Business held a panel discussion on the current economic crisis. This discussion was part of the School's Business Convocation series and was open to the public. The panel was designed with two components in mind. First, a pair of academics with expertise in financial institutions and business cycles offered historical and theoretical perspectives on the crisis. Second, a pair of professionals – a local banking official and a fund manager – offered perspectives on the current financial situation and practical experience based on the policy responses to past crises. As moderator, Joe Baker asked each panelist to make a short presentation on a question of general interest that was related to their area of expertise; this was followed by an open question and answer session. The participating panelists and opening questions follow.

1. Stephen Evans, Professor of Finance: Dr. Evans teaches courses on financial institutions and was asked to provide background of how the crisis occurred and what the proposed government bailout plan is expected to accomplish.

2. David Tufte, Associate Professor of Economics: Dr. Tufte is a macroeconomist and was asked to discuss the macroeconomic implications of the crisis in such areas as inflation, interest rates, economic growth and unemployment.

3. Mr. Robb Kerry, Chief Credit Officer of ADB Bank: Mr. Kerry has an extensive background in banking as a bank regulator and banker. Mr. Kerry was asked to discuss the implications of the crisis on banking credit and lending.

4. Mr. Steve Harrop, Finance Professional in Residence: Mr. Harrop was a mutual fund manager for several decades before joining the School of Business faculty where he teaches investments and manages (pro bono) an investment fund. Mr. Harrop will discuss the implications of the crisis on the stock and bond markets.

I. STEVE EVANS
FINANCE PROFESSOR

As is characteristic of capitalistic societies in general, America seems to have a proclivity for financial crises, and frequently these critical situations are caused by unsustainable growth in key industries. Such was the case in the 1890s when the overbuilding of railroads in the United States led to a severe economic downturn. It was also the case in the 1920s when speculators in the stock market drove the price/earnings ratios to levels that averaged over 100 to 1 with some stocks at five times that amount (see Faulkner, 1960, pg. 644). These unsustainable prices finally led to the dramatic market collapse that began on October 29, 1929 and which plunged the nation (and the world) into the Great Depression.

Beginning about the second quarter of 2007 (depending on which economic indicators are evaluated), a similar “meltdown” emerged with its origins being primarily in the real estate market. As we near the end of 2008, we find that the financial crisis has spread to other key industries with banking, securities, and the risk management industries being notable examples. The crisis has reached such epic proportions, that the U.S. government is now in the process of implementing corrective measures including the so-called “bailout program” of approximately $700 billion.

In all of the financial crises of our nation’s history, the federal government has stepped in to assist with or to provide solutions. For example, the savings and loan “meltdown” of the 1980s was primarily caused by significantly rising interest rates—largely a result of the energy crisis of the 1970s. The increased costs of borrowing on the liability side of the savings and loans’ balance sheets could not be adequately offset by increasing interest income on the asset side because of the fixed nature of the long-term mortgages. These institutions (and the millions of depositors whose savings were affected) had to be bailed out by the 1989 legislation known as FIRREA and other legislative actions.

The savings and loan crisis have cost American taxpayers tens of billions of dollars over the two decades that have followed, so by this measure the $700 billion “bailout” for the current crisis seems “proportional” and reasonable. However, there is a particular irony in the government’s efforts to implement the “current” bailout program, and that is the glaring fact that the government itself has been the primary cause of the problem. However, before analyzing these causes, it seems appropriate to highlight a few factors that have been mentioned as possible causes of the current crisis that have not proven to be primary contributors (see Liebowitz, forthcoming).

First, it might be suspected that unscrupulous lenders have caused the problems by taking advantage of people who haven't understood the mortgages they have been getting into. While there have undoubtedly been many situations of this type, they have not been the primary cause of the real-estate meltdown. Rising interest rates might also be considered initially as a factor in the meltdown, but there is not sufficient evidence to conclude that interest rates have been a significant factor. There have been other times in our nation's history when the speed of interest rate increases has been more dramatic and when the level of interest rates have been higher, but these have not resulted in mortgage meltdowns.

Also considered a possible cause of the problems has been the use of adjustable rate mortgages, and certainly statistics show that those who financed with adjustable rates are a larger proportion of those who have lost their homes than those with fixed rates, but that has not been the primary cause of the meltdown. Canada and many other countries have made significant use of adjustable rate mortgages for decades, but they have not had real estate meltdowns. Lastly, there is a tendency to think of real estate speculators as the cause of the real estate meltdown and resulting crisis. Certainly, speculators became a secondary factor, but they were not the primary cause.

So, what has been the primary cause? The answer lies in the fact that the government became involved in the real estate industry and mandated that lending institutions make loans to people who had not previously qualified for loans. The origins generally go back to the Great Society of the 1960s and the so-called war on poverty. Government started passing laws that forced private lending institutions to make loans that they had always considered unprofitable and unsafe. In 1977, for example, the Federal Government passed the Community Reinvestment Act which mandated that banks and other lending institutions make loans in poor neighborhoods and even set up reporting standards to make sure they were complying with the new laws.

But the real momentum was put in place in the 1990s when the government put further pressure on lending institutions to make sub-standard loans (referred to as subprime lending) and equal pressure on Fannie Mae, Freddie Mac, and other mortgage buyers to purchase the loans. Making such loans required banks and mortgage purchasers to relax the lending standards that had been in place for decades.

The government called it "mortgage innovation," and the term meant that standards on such things as down payments, income to debt ratios, employment histories, and formal credit ratings were to be largely abandoned. For example, down payment standards that had traditionally been 20% to 30% of asset values were frequently eliminated, and many poor people were able to get into homes with "no money down".

With millions of people (who had not previously qualified for home loans) finally being able to make the purchases, it caused a tremendous increase in the demand for homes, and the inordinate demand started driving up home prices. As the upward trend increased, it caught the attention of other speculators in society (both wealthy and poor), and they also began "jumping on the bandwagon" at increasing speed. This further increased the demand for homes and the prices of the homes. Although warnings were given by people both in the housing industry and in government, the "feeding frenzy" continued unabated, and the result was an unsustainable increase in prices—what is aptly called a bubble economy. It is an appropriate term because a bubble always bursts, and an unsustainable level of prices will also begin tumbling down at some point.

When the housing market started coming apart, especially in 2007, panic set in and many people started bailing out. With an increasing supply of homes on the market and a decreasing demand for these homes, values and prices began declining at an accelerating rate. The financial impact and panic became especially acute among those who were "upside down." In financial terms, being "upside down" (or "under water") means that a mortgage on a home is greater than the value of the home because of declining home prices. Those who are wealthy often have a tough time dealing with it, but those who are poor are especially devastated, and frequently "wiped out."

Many homeowners who got into homes they couldn't afford knew their circumstances were such that they couldn't afford the homes in the long run, but they speculated that the rising home prices would allow them to make a quick profit when the homes were sold at inflated prices. Now the bubble has burst, and the meltdown continues. There are a lot of ways of helping poor people but putting them into homes they cannot afford is not a good way to help, and hundreds of thousands of people are now losing their homes and/or going bankrupt. For example, a government report indicated that in October alone, 85,000 homes were lost which was a 25% increase over October of 2007 (see Clifford, 2008).

The financial and economic damage to the homeowners is only the beginning of the problem. The damage to the banks and other lending institutions has also been catastrophic. A dramatic increase in foreclosures has resulted in a significant loss of income, a dramatic increase in operating costs, and a resulting drop in the values of the common stocks of the lending institutions. So, what started as a crisis in the real estate industry has moved to the lending industry with several large financial institutions having already gone bankrupt.

But the tenuous situation does not stop there. An additional problem is the fact that the “bad mortgages” established by the lenders have been “bundled up” in investment packages and sold by the lending institutions to such mortgage purchasers as Fannie Mae and Freddie Mac. What they’ve ended up with are massive amounts of paperwork that are impossible to fully scrutinize, and the effects of the bad mortgages (mixed in with many that are good) are not fully discovered until there is a downturn in the market, and then it is too late.

All of these destructive elements were anticipated years ago by many financial services experts. In the 1990s, as the Federal Government was mandating relaxed lending standards and increased subprime lending activity, there were many who warned of the dangers that such government involvement would create. For example, a 1999 article in The New York Times by Steven A. Holmes stated that “Fannie Mae, the nation’s biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people and (has) felt pressure from stock holders to maintain its phenomenal growth in profits” (see Holmes, 1999).

In a Wikipedia article on Fannie Mae, it states that “In 1999, Fannie Mae came under pressure from the Clinton administration to expand mortgage loans to low- and moderate-income borrowers. At the same time, institutions in the primary mortgage market pressed Fannie Mae to ease credit requirements on the mortgages it was willing to purchase, enabling them to make loans to subprime borrowers at interest rates higher than conventional loans”.

The Wikipedia article then quotes a 1999 article from The New York Times that states “that with the corporation’s move towards the subprime market, ‘Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s.’”

Alex Berenson of The New York Times reported in 2003 that Fannie Mae’s risk is much larger than is commonly held. … Nassim Taleb wrote in The Black Swan, “The government-sponsored institution Fannie Mae, when I look at its risk, seems to be sitting on a barrel of dynamite, vulnerable to the slightest hiccup." "And then Peter Wallison, a resident fellow at the American Enterprise Institute, said that "From the perspective of many people, including me, this is another thrift industry growing up around us. If they fail, the government will have to step up and bail them out the way it stepped up and bailed out the thrift industry."

Over the years there have been many appeals to Congress to deal with the potential crisis, but neither the U.S. Senate nor House of Representatives have been willing to act (see Hume, 2008). For example, in April 2001, the (White House) appealed to Congress to deal with the situation stating that the potential problems could "cause strong repercussions in financial markets." Then, in 2003, the administration upgraded the problem to "a systemic risk that could spread beyond just the housing sector." In further appeals to Congress to push for a new Federal Agency to supervise Fannie Mae and Freddie Mac, John Snow, the Treasury Secretary, appealed to Congress stating that "We need a strong world class regulatory agency to oversee the prudential operations of the GSEs and the safety and soundness of their financial activities."

On February 17, 2005, Alan Greenspan stated that "Enabling these institutions to increase in size, and they will once the crisis in their judgment passes, we are placing the total financial system of the future at a substantial risk." Then on April 6, 2005, Alan Greenspan added that "If we fail to strengthen GSE regulation, we increase the possibility of insolvency and crisis."

In a further appeal to Congress on May 25, 2006, Senator John McCain gave a speech to Congress stating that "For years I have been concerned about the regulatory structure that governs Fannie Mae and Freddie Mac and the sheer magnitude of these companies and the role they play in the housing market. The GSEs need to be reformed without delay."

In spite of these and many other warnings by industry watchers and government officials, the excesses and abuses of key industries have continued to run unabated, and now the economies of the United States and other industrialized countries are in great peril. As a nation, we have seldom faced challenges of such magnitude and complexity, and all of us can only hope that the measures being taken by those in power are adequate to stabilize and correct these difficult situations.

The $700 billion bailout program that passed in October 2008 is known as the "Emergency Economic Stabilization Act of 2008, and it is interesting that the original bill was only three pages long. With many details added to the program (and a lot of "pork" by the legislators involved), the program was increased in size to over 1,000 pages. The bailout plan calls primarily for the purchase of hundreds of billions of dollars in illiquid mortgage backed securities (MBS) so there will be more liquidity in the industry for new loans. Most of these purchases will be at discounted prices. For example, Merrill Lynch has sold its mortgages to the government at 22 cents on the dollar (see Floyd 2009). The government will be entitled to any income received on these mortgages and will also attempt to sell them as opportunities present themselves.

Financially, the $700 billion legislation will cost the average American about $2,300 (see Wingfield and Zumbrun, 2008), and the average working American will have an added burden of about $4,635 (see Kersten, 2008) … But that is just the beginning of the burden on taxpayers. Since the $700 billion legislation, other legislative bills have also been passed adding hundreds of billions of dollars to the burden, and no one really knows how much the catastrophe will cost in the long run. In the meantime, let us all hope that the efforts put forth will serve to strengthen Main Street and not just bail out Wall Street.

II. DAVID TUFTE
ECONOMICS PROFESSOR

I have prepared about five hours worth of stuff for my ten minute presentation here. That has been a problem with this crisis: there are so many details out there that it is really difficult to encompass all of them. Anyway, I've been asked to limit my discussion to macroeconomics, which is good, because I will have less to say.

What really strike me about this crisis is that no one really cares about the macroeconomics itself. All that people want to do is use the macroeconomic data they see as justifications for agendas that they already have. You don't hear anybody say this is a cause for less regulation or different regulation. It's always a call for more regulation, more centralization of policy, and less reliance on individuals making the best decisions on the ground. That can't be a recipe for success.[1]

So, let's talk about the macroeconomic situation and how things actually look. We have bad mouthed the economy for a couple years now and that is really misplaced (Gallup 2005 reported low numbers for the economy in the middle of the what turned out to be the nation's fourth longest expansion). The economy is not

[1] Since the panel discussion, the Obama administration and the 111th Congress have passed the primarily regulatory Fraud Enforcement and Recovery Act of 2009, and the Credit Card Accountability, Responsibility and Disclosure Act of 2009, the primarily centralizing Edward M, Kennedy Serve America Act, the Omnibus Public Land Management Act of 2009, and the Helping Families Save Their Homes Act of 2009, while the American Recovery and Reinvestment Act (i.e., the stimulus package) has both regulatory and centralizing aspects, as do the two acts passed by the Bush administration and the 110th Congress – the Emergency Economic Stabilization Act of 2008 and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008.

doing well but it's not doing horribly either. On a letter grade scale, we've been pulling solid C's here (the letter grade system developed by David Tufte at voluntaryXchange and illustrated at Gongol reported a "C" for the quarter preceding the panel discussion). We are not failing by any means. That may, and probably will change, but it's always good to start with an honest assessment, and that's been lacking in the legacy media.[2]

Last night I got some GDP data and looked at the last five most recent quarters. This roughly corresponds with the first serious symptoms.[3] If you look at the growth rate that we have actually gotten, the last time we had a situation where real gross domestic product growth was so weak for 5 straight quarters, without actually going negative, was July of 1996 (see Bureau of Economic Analysis).

For perspective, it's useful to think about that date. In July of 1996 we had a sitting incumbent president that was expected to easily get re-elected. In retrospect, it isn't surprising that the Republicans put up against him a guy that stood around in line long enough to get to the front, with no particularly special qualities. We weren't worried too much about the economy then. So, it's good to ask who benefits from bad mouthing a similar economy over the last several quarters. This is probably a good time to remind you that I'm limiting my discussion to the macroeconomics here: my point is not that the financial problems of the last 5 quarters aren't large, but rather that they haven't translated into macroeconomic problems in a serious way yet.[4]

Now, I'll add a couple of other issues that are more about recent economic events. It's going to seem kind of odd to think about these things, but macroeconomists know to look for many small signals in the noisy data rather than "one big cause" (see Diebold and Rudebusch 1989), so I think it's worthwhile to bring these up because they're going to get suppressed in the non-macroeconomists search for the "one big cause". This latest round of trouble started about a month or so after the Olympic construction got finished.[5] Essentially, the biggest expansionary fiscal policy project in the world just ended (official Chinese numbers are always dubious, but Rabinovitch 2008 reports spending of no less than $40 billion). If we are going to think seriously that a fiscal stimulus package coming out of Washington is going to

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[2] James Hamilton, author of the most widely accepted and publically available statistical predictor of recessions (see Econbrowser) produces a recession prediction index that started rising in 2007 IV, but did not enter recession "territory" until 2008 III (both "predictions" were made with a 4 month lag after the end of the quarter.

[3] Note that this panel discussion was held before the declaration by the NBER business cycle dating committee that the economy peaked in December 2007.

[4] Recent revisions to real GDP data show declines through 2008, but at the time of the panel discussion, real GDP had only declined in 2 of the previous 4 quarters, and further those were very modest declines.

[5] This is anecdotal, but the speaker knows an architect who worked on the Games' facilities who can confirm that construction was not completed on some structures until after the Games had officially begun.

boost the economy, then in order to retain our credibility we need to also acknowledge that the Chinese just slammed on the brakes of the global economy (note that the popularized dollar value of the Obama stimulus package is much larger). Experts may argue about the importance of that to other economies, so it should be emphasized that Olympic spending is a lot more like textbook fiscal policy than any of the stimulus proposals that have come out of Washington (see Colander 2007). Around that time we also had Russia invading Georgia. Russia found this to be a public relations disaster. As a result, already declining Russian markets went into a complete nosedive, and actually shut down a couple of times before the Lehman Brothers bankruptcy (Bahkarov 2009 reports that the RTSI index lost over 60% of its value between its July 4 peak and the time of the panel discussion). This is only part of the documentable increase in international financial volatility in the weeks preceding the U.S. financial crisis. Lastly, we have the failure of IndyMac in mid-July. There is general agreement that IndyMac was in declining health, but that its demise was hastened by ill-timed news releases on the part of a U.S. Senator. This is symptomatic of a more general loss of faith in decentralized decision-making by the Washington policy elite (see Postrel 1999). Reasonable people can argue about the importance or selectivity of this list, but I think we can agree that there has been a widespread move by centralized decision-makers towards contractionary policy, destabilizing political moves, and poorly grounded brinksmanship. Macroeconomics is hard precisely because past turning points end up being attributed to a preponderance of small negative shocks rather than a single large one (see Diebold 1999), and my goal here is to emphasize that we have no shortage of alternative candidates that would lead us to focus on American financial problems as the sole explanation of macroeconomic outcomes.[6]

So this is not just the U.S. If we go out and look at other countries around the world, the financial problems that they are having in other countries are often worse. We think about causality as involving the progression of time. Over the next several months I envision people blaming the Lehman Brothers bankruptcy and events that followed for bad macroeconomic outcomes, but it is useful to keep in mind that it too was caused by things that preceded it, and these three events stand out.

We also have learned that Iceland is in complete collapse, and the currency system has started to come apart at the seams; there are actually credible reports of people selling bags of foreign currency on the internet in Iceland. Hungary is close to that stage as well. If we look at Ireland, the UK, and Germany—their bailouts are actually larger in proportional terms than ours are. So, this is a much bigger problem than just the U.S. but you don’t hear many people talking about that fact. Why are we

[6] It is arguable that the early payback of TARP funds by financial institutions in 2009 supports the argument made here in 2008.

so uptight here if problems are actually bigger in other places? I'm not denying that it is a big problem here, but maybe we need to be a little less self-centered about this.

So, how are things actually going? Well, I'm not saying this is not a recession that we are currently in, and I'm not saying that we are not going down a downward path. We just don't know the actual scope of things.

I will say we are paying too much attention to things like the stock market. We pay attention to the stock market, because it's easy and it's sitting right on TV in front of people. The same goes for the policy discussions coming out of Washington. It's a lot easier to watch this on TV than to dig through the actual data where the truth lies. For example, the real action in this crisis is in bond markets and the bond markets are harder to observe. If we look at those bond markets they were horrific in late September — they've eased up a little bit, but we aren't talking about the bond markets enough (see Ross, Westerfield and Jaffe, 2002, pg. 107 for a discussion of the thinness of readily available information on over-the-counter bond markets).

It troubles me when people ask "Is this like the Great Depression?" when the answer is probably not—probably not at all.[7] Could it be that bad, well, yes, anything could be that bad, but that's a thought that is almost free of content. There is no way to tell about that right now, and it certainly doesn't look that way. It's got some suspicious tendencies, I'll give you that much, but it is nothing like a certainty. This is an opinion that we don't see voiced enough in the legacy media right now.

So, let's think about what we know about macroeconomic turning points and recessions. What we know about business cycle turning points is that they are almost unpredictable (see Sichel 1991). We know that the magnitude of recessions is almost unpredictable. We know that the length of a recession is almost unpredictable (see Zarnowitz 1992). We can make small improvements over guesses about those three issues, and that's it or (see Durland and MacCurdy 1994). You don't hear enough people on the news, saying "We can't tell exactly how bad this is going to be". All that you hear people say is "this is horrible, it's like the Great Depression, we are all going to lose our houses, our retirement, and all this other stuff, and we are going to have 25% unemployment". There is no basis for anybody making those morbid claims at all. It's always possible. But what we've done is gone from perhaps a one in a hundred chance to maybe a two in a hundred chance of that happening this year — which suggests that it's still not a reasonable thing to be very worried about.

[7] Since the panel discussion a large literature has documented how unlike the Great Depression the "Great Recession" has turned out not to be; including many people normally associated with emphasizing the severity of the current situation such as Krugman 2009.

Having said that, if we look at the Great Depression, what people want to see is that the Great Depression – or at least part of it – was a financial panic. So, the next obvious question is whether this financial panic is like the financial panic we had then. The answer again is no. In the Great Depression what we had was a couple of years of real value in the economy being destroyed. After that the banks started running into liquidity problems that needed to be addressed or else, we were going to lose financial value too. At that point the Federal Reserve blinked, and we had a huge loss of financial value (see Friedman and Schwartz 1963). That is not what is going on in this case at all. This time around the real value is still there. All these houses built for people who can't afford them—the houses are still there; the real value is still out in the economy. But what we have done this time around is lost all this financial backing first. That makes this financial crisis very much unlike the one that occurred over the first four years of the Great Depression. That does not mean that a depression cannot happen this time around, but it does mean that it can't happen the same way that it did, and that should be a comfort, albeit a cold one.

The current situation is different than the Great Depression in that, then, there was a threat that we were going to lose financial value if the Federal Reserve blinked and didn't do anything, and it did blink, and the economy did lose that value. Contrast that with the current situation: we've already lost the financial value, and popular expectations are that we ought to do something about that. Without prejudice against current policies or plans, it should be clear that there is a non sequitar here: the Great Depression was a situation of doing A might prevent B happening, while the current situation is one of B already happened with a hope that doing A after that fact might undue B. It might work out that way, but I won't hold my breath.

The bottom line is, we see a lot of people using the macroeconomic situation as an excuse to propose policies that they had in the back of their mind anyway, except that now they feel this is a politically expedient time to do it.[8] In particular, we see a lot of calls for using macroeconomic rather than financial outcomes to impose financial rather than macroeconomic regulations.[9] This is in spite of the fact that there is little objective evidence of relaxation of financial regulations over the last generation or so on those major corporations that are currently the target of so much ill will (see Colomiris 2009). We also see a lot of calls for using the data collected – by centralized decision-making institutions to describe what the decentralized decision-makers are doing – to justify shifting decentralized decision-making authority to those same centralized institutions. In both of these, my verbiage is

[8] Since the panel discussion, many have become familiar with the quote from Rahm Emanuel, President Obama's Chief of Staff: "You never let a serious crisis go to waste. And what I mean by that it's [sic] and opportunity to do things you think you could not do before."

[9] Barney Frank, chair of the House Financial Services Committee: "It is because the fight against the harshest aspects of unrestricted capitalism is therefore a political problem and not an intellectual one that community action remains so essential."

necessary to highlight the intellectual sleight-of-hand on display from politicians and pundits.

III. ROBB KERRY
BANKER

There have been a lot of people saying that banks don't have any money to lend. I want to first tell you it's not entirely true for every bank out there. We have money to lend; feel free to drop by. However, there is a phenomenon occurring throughout most of the financial sector right now, and many banks do not have money to lend. I would like to take just a minute and talk about why that's the case when there have only been a select few banks that have actually failed.

We've talked about Lehman Brothers. Merrill Lynch has had its share of problems. Washington Mutual and a handful of others have appeared to have catastrophic collapses. So the question is, how does this affect every other bank throughout the economy, and does this affect banks in our local area?

Let's talk for a second about how banks operate. Banks get funding to loan money primarily from two sources: they have capital, which is the money that owners put in, typically by buying bank stock; and they take deposits. Let's take a sample bank and say their owners invest capital of $10 million. Then they take in deposits, which are the primary source of funding for community banks. Let's say the sample bank takes in $90 million in deposits. Now the bank has a 10:1 financial leverage ratio, meaning that for every dollar of assets the owners have invested $0.10 of capital. This leveraged balance sheet is a potentially profitable scenario, because the bank pays a lower rate to its depositors than it charges its borrowers. The bank may pay a CD rate of 3.50% to 4.00%, but it may lend those funds to its borrowers and collect an interest rate from 7.00% to 9.50% or higher, depending on the type of loan.

Some people look at this scenario and say that it's unjust, because the bank is making a spread using funds that are not theirs. Yet when you consider the financial risk of this scenario, particularly with the 10:1 financial leverage ratio in the balance sheet, you can see that this scenario may not be so unjust. In fact, the financial risk of this scenario is why a lot of banks don't have money to lend at the moment.

Going back to our sample bank, the $90 million that was effectively borrowed from the public by accepting deposits was loaned out at a 10:1 financial leverage ratio. However, any losses realized on those loans come directly out of capital dollar for dollar. The depositors who provided the funding do not share in the risk or the losses. So, putting some numbers into this scenario, because the sample bank funded

$100 million in assets with $90 million of deposits and $10 million of capital, if the bank experiences $5 millions of loss in its loan portfolio, that loss represents only 5% of its assets, but 50% of its capital is now gone. This puts the bank's capital below regulatory minimum capital levels, which causes regulators to come in and demand immediate corrective action designed to restore appropriate capitalization. At this point, the bank will have three main options: they can raise capital internally or through public offerings; they can sell the bank to someone with adequate funds to recapitalize it; or they can sell their loans to reduce the overall size of the bank.

In our current economy, with most investors worried about banks and the financial sector in general, there won't be too many people standing in line begging to buy the stock of a troubled bank that's being forced to raise capital, so that option is unlikely to be successful.

The second option, selling the bank, is also undesirable because a troubled bank with inadequate capital would sell at a tremendous discount. There will be shareholders who have invested much of their wealth and their livelihoods into growing the bank who will oppose the sale. There are also community factors to consider. If a large national bank buys a small, troubled community bank and folds it into its large-bank business model, will the residents and businesses of the community receive fair representation when they approach the new bank to establish deposit accounts or apply for credit? Again, the community factors will pose a tremendous barrier to the owners selling the bank.

Finally, the bank can get rid of some of their loans, thereby reducing asset size and overall risk exposure, and return to a more appropriate capital ratio. In this option, because of that 10:1 financial leverage ratio, the bank would have to sell off much more than $5 million in loans to offset the $5 millions of lost capital. In fact, the bank probably would have to sell at least $30 million in loans.

This is the situation that many banks find themselves in right now, and it's the source of their inability and/or unwillingness to lend. They have not experienced the catastrophic failures that are covered on CNN and Bloomberg, but they have experienced portfolio losses and write-downs that have forced them to take action and strengthen their balance sheets. They are unable to write many new loans, and they may even be trying to unload a portion of their old loans at the same time.

I hear a lot of talk about liquidity, and I'll move on to that subject for a moment. Liquidity in the banking world really means two things: it means having access to funding and the ability to convert that funding into loans. At the moment, there's little funding available because the bond market has taken a terrible beating, which somehow has not gotten the same amount of attention as the Dow Jones' price swings. A large amount of our nation's lending is funded indirectly through the issuance of bonds, which are backed by the various loan products they fund, and the vast majority of industrial investors simply are not interested in buying these types of bonds.

Over the past decade the mortgage industry received amazing influxes of liquidity by issuing mortgage-backed securities, which were considered safe and highly desirable instruments for many industrial investors. Now that the value of these bonds and their underlying collateral has come into question, most decision makers are no longer interested in investing in them. As a result, it's become much harder for a large lender to package loans and issue bonds. This type of activity is possible, but the market has drastically changed its tolerance for certain loan products as collateral for these bond issuances. Consequently, most of the loans that large, troubled lenders would like to unload are no longer acceptable for securitization activities. That creates the illiquidity we've heard so much about—lenders are unable to generate funding for new loan underwriting, and they are unable to generate liquidity using their existing loan portfolios.

This illiquidity has put a tremendous squeeze on most lenders, large and small. A lot of banks are in such a predicament that if you inquire about a loan, they really will not seem too interested. This is the exact opposite of what borrowers have come to expect over the past decade, and quite a few of them are shocked to discover how much lenders' attitudes have changed. In reality, it's not that the bank doesn't like you. It's not that they think ill of your community. They simply are not in a position to generate new loan volume.

I think under the circumstances of our economy and financial sector, we'll probably see quite a few consolidations over the next year or two as banks continue to recognize and realize losses and write-downs. With illiquid portfolios and few options for raising capital, it's likely that some of the impaired financial institutions out there will be acquired by larger entities with more ready access to capital and more liquid balance sheets.[10]

This brings us to the critical question for this group, how does all of this affect us locally? I'm a community banker. That is what I've been for most of my career, besides being a bank regulator. I've never worked for a large bank, and I've stayed in fairly small communities. From my perspective, I think the most affected group right now will be small businesses. Small business loans in general have typically been

[10] Since the panel discussion, there has been a wave of mergers and acquisitions in the investment banking and brokerage industries.

perceived as somewhat speculative. A small business owner may request a loan to start a new business, expand an existing business, or just get working capital so he can meet his payroll. For example, it may be a plumber who goes out and does a job at somebody's home, and he typically doesn't get paid for a while until after the job is completed. If he does a job under a general contractor who's building a spec home, it might take quite a while before he gets paid. In the meantime, the people who worked with him on the job, the suppliers, and the gas station that puts fuel in his truck, they all expect to be paid today. Businesses borrow money for working capital that is supposed to bridge those differences in cash flow. These businesspeople come in for a loan and they're typically not in a position to offer a lot of collateral, and it's usually a difficult loan to get approved—right now it's even more difficult. Banks that have reduced capacity to lend are going to find it very hard to supply credit to small businesspeople. That is damaging to an economy—it's definitely something we don't want to be pervasive.

How do our economy and financial struggles affect consumers? It really depends on whether you're looking to deposit or borrower, what you are trying to buy with your borrowings, and whether you've got the ability to make a reasonable down payment.

If you're a depositor, the news is fairly positive. Deposit rates are quite attractive right now, especially when compared to recent performance of our equity markets or compared to yields on other "risk free" investments, such as Treasury instruments.

If you're a potential borrower, those attractive deposit rates are working against you at the moment, especially when compared to some of the traditional indexes (such as Prime), which have become out of touch with actual borrowing rates. Borrowing costs are still fairly reasonable for the most creditworthy borrowers, but rates have become somewhat unattractive for the more "average" borrowers, especially commercial borrowers, and prohibitively high or even unavailable for high risk or subprime borrowers.

Tying these realities to our everyday lives, if you want buy a home but you don't have any money to put down, your income is not very stable or hard to document, and your credit score is not so good because you've overextended yourself or had some trouble with payments in the past, I'm sorry to say it might be very difficult for you to finance a home right now. Conversely, if you are in a position to bring 20 percent cash into the transaction for the down payment, if you've kept your credit record in good condition, and if you've got stable income and reasonable capacity to repay—meaning that you don't have an excessively high debt-to-income ratio—I don't think you will be too affected by this credit crisis. That type of funding is still available; there are still government programs to promote this type of lending.

The same scenario applies to other types of consumer credit, such as buying a car. If you are looking to buy a vehicle, you might have a challenge getting that done through Ford Motor Credit or GMAC, both of which rely heavily on bond funding. But your local community bank is probably in a pretty good position to help you with a request like that. If you've got a credit score that compliments you and you've put some money down on the automobile, you should be able to find reasonable financing.

As a consumer and possibly as an investor, there's even a little bit of an upside to our current economic situation, depending on the position you are in. Right now, many people are panicking, which is not necessarily the wise thing to do. We've seen some fire-sale prices recently. People who have liquidity right now, investors who can step up with cash in hand and consummate a transaction without relying on outside financing— these are the people who can really benefit from our economic challenges.

Equity prices have plummeted. P/E ratios are at historic lows. Housing prices are way down. If you're looking to refinance your home or sell your home, that's bad news. However, if you're moving to the area to buy a home, you might pay less now for a decent house than you would have even three or four years ago. And again, if you have some money for a down payment, a decent credit score, and reasonable income that you can document, it's very likely you can find attractive financing to help you buy that bargain house. From that perspective, the future doesn't look quite so bleak.

In conclusion, our financial sector deals in risk, and it does so with a highly leveraged balance sheet. Recent and ongoing losses and write-downs have rapidly eroded the capital bases required of lenders, forcing them to seek new capital and possibly consolidate, but more notably it has reduced their ability to lend. Illiquidity in their loan portfolios and in bond markets has further reduced their ability to lend. This has the potential to stunt the growth of small businesses and even impair their ability to satisfy current liabilities and fulfill contracts, which is an immediate and substantial concern for our entire economy. On a consumer level, lending also has been restricted, but reasonable financing options remain available for borrowers with adequate down payments, decent credit records, and reasonable documented incomes. On the upside, for those consumers and investors with liquidity, there are many equities and assets available at very attractive prices. Accordingly, despite the challenges we face, the future is not a complete loss. There are some positives.

At the end of the day, the United States still has a good work ethic, a productive workforce, and a $13 trillion annual GDP. I believe that now is a time to tighten our belts a bit, adapt to our current financial environment where possible, work to improve that financial environment where adaptation is not a viable option, and look forward to the future with prudent and cautious optimism.

IV. STEVE HARROP
RETIRED FUND MANAGER AND PROFESSIONAL-IN-RESIDENCE

I want to go back to a couple of points made by Steve Evans. Most of you know about the television commercials of a few years ago teaching us how to become real estate tycoon, right? This is how you do it, we've got a book, buy the book, do this and you are going to be very, very wealthy—very, very quickly. And you've seen the graphs of home prices that for a decade were fairly steep, going up. It attracted, not just the individual of modest means who is anxious to get into his home before prices rose, but also speculators of considerable means—individuals with a lot of money, with deep pockets that decided they would build spec homes: sometimes 5, sometimes 10 spec homes. And of course, when prices began to fall — those individuals were the first to try and sell: let's get out of this hole now because we can't afford to carry 5 or 10 homes. Even so. spec homes have and are still dragging very wealthy people down. It's not just the individual of modest means who is defaulting on his mortgage. It's everybody who has speculated or who has falsified a mortgage loan application or who has tried to get in on the government encouragement to try to participate in a market that was only going to go up. That was domino #1.

Domino #2 is the fact that mortgage market /real estate market is supported by debt. Almost every real estate transaction has a mortgage, and unlike much of what we do in the economy — most of it is done by debt. Mortgage debt has traditionally been a very sound investment. Institutions who are conservative would buy mortgages — historically with default rates of less than one-half of one percent –insurance companies, brokerage firms, banks, and it has been a good investment. Let's not fault these individuals for buying something that for decades has been sound. But what we found is that the mortgage wasn't the same as it used to be. That mortgage was held by the speculator who had 10 homes he was trying to carry. That mortgage was held by a person of modest means who couldn't afford it. That mortgage was a virus and that virus began to infiltrate the entire financial system. Everybody who touched a mortgage; banks, insurance companies, savings & loans, brokerage firms, domestic and foreign – everybody was hurt, because the mortgages began to default—Domino #2.

Do you see a pattern here? The pattern is debt. Now we come to the third domino — the consumer – who for decades has mined the equity out of their home with home improvement and second loans. Those who, for example, saw that the value of their home was up $30,000, and borrowed that to buy a boat or RV. At this point in time that value is not only gone, but he owes more on his home than it's worth. We are down 20- 30%--the home markets are down much further than that. So, the consumer for decades has mined the equity out of his house, finds that source of wealth gone, and he is scrambling to make payments. Now consider his position. He has lost his equity, his down payment of 20% gone, up in smoke—it isn't there anymore. At the same time, he's looking at the stock market that is down considerably. Do you know what the high point of the Dow was – 14,163 a year ago. We've had this hit occur in 12 months. So, he doesn't have his home to go to, he's looking over his shoulder at his pension, as Joe Baker just pointed out, and he's wondering, "You know, I'm a poor person. I don't have any money anymore. I've got too much debt, and my assets have shriveled up and gone away. What do I do?" Stop spending—domino #3

As the consumer stops spending, all of those individuals that are dependent on the consumer are going to be hurt. You've seen the story in autos, some of you have seen the retail sales reports — it will get worse. We are at the point now where multiple dominos are falling as this debt infiltrates the economy and begins hurting not just the consumer, but the institutions that rely on the consumer.

What we can say about the government actions as hurried as they are, is that sometimes you throw everything against the wall and see what sticks. I was having a conversation with a member of Congress the other day; he gave a little insight into that program. He said to me that when Secretary of the Treasury Paulson and Federal Reserve Chairman Bernanke sat down with the leadership of the House, they told them they had 5 days to do something. Five days to do something before the economy would fail. So, Congress is running scared. They didn't know quite what to do. So, we have everything thrown against the wall to see what will stick. We have 3-page proposals to spend $700,000,000,000 and it has been pointed out that it's just growing since then, as we try and get a handle on the debt, this virus, this toxic waste, that has infiltrated the economy. Are we going to be successful—YES. The Federal Reserve will win. They always do. It's just a matter of time, but while we wait for those programs to get traction, the consumer has stopped spending, small business is struggling, and large business is going down: big institutions laying off thousands; the unemployment rate will go up. But once these programs begin relieving the economy of this bad debt, once institutions feel free to lend again, once the consumer begins to get confidence that maybe we are at the bottom of real estate prices, maybe we don't have another 20% down to go. Then things will start to rebound. Bottom line—we'll probably have another year or so of weak economic and financial numbers. At that point we are going to be bumping along the bottom. Will the stock market go down some more – maybe. But, remember the stock market is a leading indicator. It anticipates that unemployment is going to go higher, it has already accounted for that. And we will continue to be volatile as some of these numbers delay getting traction, but as they get traction, the recession we are experiencing now will be shallower and shorter than the recession would have been without these programs.

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