The Credit Crisis and its Potential Resolution

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Can we resolve the credit crisis and can we do it without destroying the world economy in a re-run of "The Great Depression"?

There is an old joke where the punchline is "If that's where you are going, I wouldn't start from here". **We have to face the fact that there are no longer "good" answers to the credit crisis, there are only "least bad" answers.**

While housing may well have been the trigger for the onset of the broader financial turmoil, we do not believe it is the fundamental cause. A strong case can be made that the main problem has been that many individuals and corporations in the Western world have been living beyond their means for too long.

For example, for the vast majority of Americans, wage growth has remained below inflation for several years, hence the average standard of living of middle and lower class Americans has declined. They sought to reverse this effect via a number of actions: firstly, they decreased their savings dramatically; secondly, they regularly re-mortgaged their properties as prices rose, taking out money to pay bills or to treat themselves to a new car or holidays – "treating the house as an ATM"; thirdly, they borrowed more money via car loans and credit card debts, which have risen to all-time highs. This growth in debt increased the risks to the banks lending the money. However, the risks of these loans defaulting could be transferred away from the lender by packaging these loans together into securities – "Collateralised Debt Obligations", CDOs or "Collateralised Loan Obligations", CLOs. As these securities paid high coupons, they were attractive to investors. This attraction was increased by the rating agencies providing high credit ratings to these securities. Whether such securities deserved such high ratings is now being discussed with the benefit of hindsight; whether incompetence in the rating agencies was to blame or fraud will doubtless be decided by the regulators and/or the courts, in due course.

When the housing market started to decline and mortgage backed securities followed rapidly, investorsstarted to question whether these CLOs and CDOs were any stronger than Mortgage Backed Securities (MBS). Their prices fell too and a downward spiral ensued.

The natural question to ask is "where were the regulators when all these mortgages and other debts were being incurred?" Remember that when debts are securitised by the bank and then sold to an investor, the risks don't reduce, they just get transferred. When every measure of all these debts was ballooning in size, when gearing/leverage was being added to them to create new securities, why did the regulators, or government, not step in and call a halt?

In order to answer this question, we will focus on two decisions. Both decisions were made not by the US Congress (although this institution is by no means blameless in this crisis) but by executive fiat in the Bush Administration. The first relates to the housing market, the second more widely; they were:

- The decision to change state regulation of mortgage issuers, to ensure that "ability to pay" and other anti-abusive lending provisions were no longer part of the lending decision. This decision barred states from clamping down on lenders who made loans to people who could not pay.
- The decision in 2004 by the SEC to lift broker/dealer leverage limits. This allowed these firms to create more MBS/CDO/CLOs, to package them up in different ways, to sell them to clients, and to keep more of them on their own balance sheets as investments. This decision was particularly extraordinary because in 2000 Henry Paulson, then the head of Goldman Sachs, had previously asked the SEC to lift those limits and been told "no"; the SEC at the time said that it believed that removing those limits was unsafe. However, in 2004 Paulson came back with the request a second time, and the request was granted as a result of intense lobbying by Wall Street firms.

These two decisions are examples of the failure of the regulators and government to protect the financial system. The error within the financial markets has NOT been too little regulation, it has been (a) too little enforcement of existing regulation (thank you the lobbyists and sleeping regulators) and (b) widespread fraud throughout the entire borrowing and lending system. Gearing/leverage then exacerbated these failures. But the main problem was the lack of morals and integrity throughout the credit/debt structure – top to bottom – coupled with the idea that short term benefits should always and in every way take precedence over long term benefits. No individual, nor politician, anywhere in the world will want to tell the electorate that they got themselves into this mess because of a lack of their own morality and integrity. It is much easier to blame "bankers" and "gearing."

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Resolution

If America and the UK now turn against free market capitalism, it will be compounding an incompetent set of errors with a fatal one. The world has tried every other financial system ever invented and they have all failed. Capitalism is the "least bad" system. **Allowing companies to fail is a natural part of capitalism, it does not show the failure of capitalism.**

In our opinion, to resolve this crisis, there are two main choices:

1) **Opaqueness** – We permit banks to continue to hide investments offbalance sheet; we suspend mark-to-market accounting; governments pump money into banks as loans. Result, we end up with continued lack of trust, where no-one will invest in anything because of lack of clarity. This lack of trust will extend not only to the stock markets and the bond markets, but also to governments' ability to resolve the crisis. This is exactly what has happened to Japan since 1990.

2) **Clarity** – We open the books and try to value everything, even if at zero. We bring everything offbalance sheet back onto the balance sheet. Yes, faith will be destroyed in the bankers and the "Masters of the Universe" in the short term; yes, markets will crash; but the crisis will be short. Governments can pump money into banks as preference shares so that shareholders/taxpayers benefit from the recovery. It may still take two to three years and it may be a very unpleasant period, but capitalism will survive and business will revive.

So the choice is simple, rather like asking how you remove a sticking plaster that has been covering a cut on your skin?

Slowly, dealing with the pain as best you can, or swiftly, creating a short sharp shock which is much more painful but over with quickly?

What we must NOT do

Here are a few of the wrong routes that we are in danger of taking, which may prove extremely damaging to the world economy:

- If the problem is that banks are "too big to fail", why do we let them merge, take over their rivals and get bigger?
- If the problem is that there is too much liquidity in the market, why do we pump in more liquidity?
- If the problem is that we do not know what investments the banks are holding off-balance sheet, why do we not insist that they bring everything back onto their balance sheets?
- If the problem is that we do not know how to value the share prices of banks, why do we suggest increasing opaqueness by suspending mark-to-market accounting of their assets and liabilities?
- If the problem is that certain borrowers have deliberately misled lenders, why do we bail them out at the expense of the prudent borrower?

Conclusion

There are no easy answers, but the start of the solution process has to be to bring everything out into the open. Then let the market decide which banks and corporations will survive. Frankly, in addition, if fraud is proved then the perpetrators must bear the consequences. Preferably, those people will be forced to repay salaries and bonuses to ensure that they and their families do not continue to benefit from ill-gotten gains. Future generations have to be taught that short term gains will not be allowed to take precedence over longer term benefits. They have to be taught that such behaviour will not be tolerated in financial markets, otherwise what example is our generation setting for them? The motto of "Get rich quick and get out before the house of cards collapses" is not a philosophy that should be applied to any serious business, much less to the world's financial markets.

If any fiat monetary system is to remain stable, the core element has to be individual discipline. History will show that the abandonment of this discipline, by both lenders and borrowers, by both banks and investors, in favour of pure greed, has been the hallmark of this crisis.

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