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The Financial Crisis: Causes, Cures and Consequences

Robert McTeer

The theme of your conference is “Embracing Change.” Now, I’ve seen a lot of change in my life, and I’ve been against most of it. Some was bad and some was good. But even good change can cause much stress. For example, a couple of years ago, I bought a new BMW, part of my midlife crisis and just last week I took it in for its first checkup at 15,000 miles. When I asked the guy when the second checkup was due, he said, “Oh, don’t worry about it. Your car will contact us and we’ll phone you.” I don’t like my car being smarter than me, and I don’t like the attitude of the woman in the navigation system when I do something that causes her to recalculate.

Positive change in the macro economy usually involves pain at the micro level. For example, it used to take about 90 percent of our population to grow our food. Now only 2 percent is required to grow even more food. The other 98 percent went into manufacturing. It’s called productivity. But the same thing has been going on in manufacturing. We keep producing more and more manufactured goods with fewer and fewer workers. Those displaced go into the service sectors.

Note how progress is measured not by a growth in the number of workers, but by a shrinkage in the number of workers. Displaced workers go on to new frontiers. And we all know that protecting the old jobs would rob us of a lot of the new jobs.

As Ogden Nash, my favorite poet put it: Progress is good, if it doesn’t go too far.

Not all innovations work out, however. Five or six years ago, mortgage brokers operating unregulated outside the banking system decided that bad loans were more profitable than good loans, assuming they could unload those loans onto someone else before they went bad. Wall Street investment banks agreed, so they bought these bad or subprime loans by the truckloads, and packaged them into mortgage pools backing mortgage-backed securities. Somehow, they got these securities rated AAA by the rating agencies and sold them to financial institutions and individuals all over the world. They started out with low teaser rates, those mortgages did, that would adjust up in a couple of years. Think time bombs and trigger massive defaults. So the mortgage-backed securities market pretty much dried up.

Those mortgages were affectionately known as ninja loans, no income, no job, no assets. How could people rationalize this sorry behavior? Well, they probably said, “House prices always go up. They never go down.” So, the borrower can always refinance before the higher rate kicks in. And, even though he doesn’t start out with any equity in the house, there will be some after a couple of years, because house prices always go up.

True. House prices have always gone up, until they didn’t. And those securities were rated AAA, until they weren’t. The time bomb started exploding and subprime borrowers started defaulting and we started noticing it in the middle of 2007. The experts reassured us that the problem would be contained since subprime loans made up only a small portion of total mortgages. Well, there were more than people thought, and the financial system turned out to be much more fragile than people thought. Think of it as having a weak immune system.

The problem was too much debt, too much leverage, not enough airborne. Leverage as you know is good going up, but bad coming down. Now, to save a little time here, I've reduced all of this to a couple of little poems that will give you the message.

The first is the cause of the crisis using a Japanese haiku: "If regular loans don't earn enough to suit us, maybe bad loans will."

And then, to describe our culture of debt: "My house is under water for sure, my car is upside down you bet, but I'm getting me a consolidation loan and finally getting out of debt."

And now, of course, everybody is trying to de-leverage. Here's my de-leveraging blues: "My capital is too thick to spread on a cracker, what I need is a Middle Eastern backer, or maybe a Chinese sovereign wealth fund would lend me back some of my money." I learned that little trick from Arlo Guthrie. "I don't want to die, I just want to ride my motorcycle."

Not only was there too much debt and leverage, but most financial institutions had large exposure to each other and contagion was a very serious issue. And that contagion was magnified by an unregulated derivatives market, especially credit default swaps.

Let's take a random example here and say that Lehman Brothers owes me \$2 billion. I might buy some insurance just in case they default. So, I go to another random place called AIG and I buy this insurance, credit default swap. It would pay off if Lehman defaults or fails. Of course a lot of other people are doing the same thing.

Now, since a Lehman Brothers failure is totally out of the question, AIG didn't see any need to hold reserves against those obligations, although they may have spread the risk around a little bit by selling credit default swaps to others in the market, giving them some of that risk. The most shocking thing that I know about credit default swaps is that you can legally buy them, even if you have no insurable interest in the target firm. That means that the volume outstanding has no limit, just as the volume of making shorts would have no limited.

Now, I might notice that a certain CEO looks a little green around the gills and, on a hunch, check out his balance sheet. I find that everything on the right side of his balance sheet is wrong, and everything on the left side is gone. So I go into the CDS market and I bet on his firm's failure, joining many short sellers in doing that. The health of one firm depended on the health of many other firms.

Now the first big domino to fail was Bear Stearns, which Chase bought with a bridge loan from the Fed. After that, things settled down for a few months. But then, in September 2008, we had several once-in-a-lifetime events that happened all at once. Washington Mutual failed and was picked up by Chase. Wachovia was bought by Wells Fargo, taken out of the arms of CitiGroup. The government took over Morgan's giants Fannie Mae and Freddie Mac which were bloated with questionable mortgages that Congress insisted that they buy or guarantee to make housing affordable to all. Bank of America rescued Merrill Lynch, without government assistance at first, as they had earlier bought Countrywide, again without government assistance. Ken Lewis, the

CEO of Bank of America has found that no good deed goes unpunished. Goldman Sachs and Morgan Stanley applied to be a bank holding company instead of an investment bank so they could have access to the Fed's discount window. With those two gone, there were no more Wall Street investment banks. That's changed. People call them bailouts, but in most cases shareholders and managers were wiped out and lost their jobs. I don't think much moral hazard was created.

Before Lehman's bankruptcy, which had huge negative impacts, many pundits on the sidelines were saying, "No bailouts, no bailouts. Let them fail, let them fail." We heard a lot less of that after they let it fail. Instead, everyone decided that the biggest mistake made by the policymakers during the crisis was letting Lehman fail. I know it cost me about half of my portfolio.

How did the Fed respond to this crisis? Well, it eased monetary policy very aggressively until the federal funds target rate was brought down from 5.25 percent to virtually 0 percent. When banks proved reluctant to borrow funds from the Fed's discount window, lest they be tainted, the Fed came up with several new innovative programs to get funds into the banking system without the tank. Most of them involved auctioning off funds. In addition to assisting in the shotgun wedding of Bear Stearns, the Fed made an \$85 billion loan to AIG to buy time for an orderly sale of assets in exchange for 79.9 percent ownership of AIG for the Treasury. That price tag has gone up from \$85 billion a couple of times, but the Treasury has taken over the obligation from the Fed. AIG has been described as a healthy set of insurance companies with a giant hedge fund sitting on top.

The Fed also purchased assets in frozen markets to get them working again. They started buying commercial paper. Remember the Fed had only bought short-term Treasury securities up until this point. But they started buying commercial paper, mortgage-backed securities and securitized consumer debt. Later they started buying longer-term Treasury securities in order to lower long-term interest rates, especially mortgage rates. And, in the process, the Fed doubled the size of its balance sheet to more than \$2 trillion.

As an academic, as a college professor, (Federal Reserve) Chairman Bernanke was an expert on the Great Depression, and he knew what mistakes the policymakers had made during the 1930s that converted what could have been a recession into the Great Depression. He was determined not to have another great depression on his watch. So his mantra became: "Whatever it takes."

Other actions that were taken included the Treasury cobbling together a guarantee program for money market funds, and a couple of them broke the buck. The FDIC more than doubling deposit insurance to \$250,000 per account and guaranteeing some non-deposit bank liabilities. And, at the end of September 2008, Treasury Secretary Paulson and Chairman Bernanke went to Congress to request money to stabilize the banking system. They got a \$700 billion program that came to be known as TARP or Troubled Asset Relief Program. Initially, the idea was to use this money to buy toxic assets from the banks, but that proved to be too difficult and time consuming. The emergency was urgent. So the Treasury went to plan B and started buying preferred stock to inject capital into the banking system to give them a greater capital buffer from those toxic assets. In exchange, they got a very high interest rate and warrants that were convertible into common stock.

Now the Fed's actions in making various kinds of direct loans and indirect loans, their security purchases, and the Treasury's TARP program have been successful, so far, in stabilizing the banking system. It's not over, the banking system is still very vulnerable, but so far it has worked. Not only have they been effective, but they aren't likely to cost the taxpayer a cent. Let me say that again, the Fed's actions and the Treasury's TARP program have been successful and they won't cost anything. They will ultimately be profitable for the taxpayer. The Fed's loans will be paid off and the Treasury has all those preferred stocks that it can sell and the warrants and so forth.

It used to be when I would say that the taxpayer would be OK, people would roll their eyes. But, several of the large banks have already paid back their TARP early. The estimates are the Treasury is earning about an 18 percent return on that. So, it's a mistake to lump these two programs together with the \$787 billion stimulus package and treat them the same.

It's a mistake to lump them together with a lot of other government spending where money spent is money gone. A stimulus package is much less effective, in my opinion, and certainly much more expensive. So try not to mix these apples and oranges.

Likewise, be careful when you hear people discuss the size of the budget deficit and the accumulation of debt. Those magnitudes are way, way too large and should be brought back down over the next few years. But, the critics have been making them seem larger by talking about 10-year totals rather than one-year totals. When they pull that little switch on you, attention is now being turned to the end game, getting the deficit back down and shrinking the Fed's balance sheet in time to prevent inflation but not so soon as to lose the gains that have been made. Chairman Bernanke believes that the greater danger is tightening monetary policy too soon. If you watch a lot of financial TV, the consensus seems to be the greater danger is doing it too late. The lesson of the Great Depression is that you should wait and don't do it prematurely or you will turn a recession into a depression.

Watching daytime TV will give you the impression that the Fed has created so much money that hyperinflation is going to break out at any moment. You will hear that view tomorrow. But I disagree with it. Under the circumstances, I don't think the Fed has created too much money. Much less money creation would have courted deflation. Now, the proof is in the pudding, and both the consumer price index and the producer price index are lower today than they were a year ago. There has been no inflation.

One big issue today is the expansion of bank reserves that have resulted from the Fed's actions. True, bank reserves have expanded but banks are holding them voluntarily as excess reserves on deposit at the Fed. They may be excess reserves technically, but in these trying times and these uncertain times they're not necessarily excess to the banks themselves. Pundits say that we need to mop up these excess reserves before banks start using them aggressively and creating inflation. But I'm reminded of a parallel situation in the 1930s that didn't end well.

In 1936 to 1937, the Fed raised reserve requirements to "mop up" excess bank reserves. Since they were excess, they didn't think it would do any harm. But the banks cut back and contracted

drastically. Why? Because the reserves weren't excess in the minds of the bankers. Banks thought they needed them for security. And I think the same is true today.

Last week, I debated Arthur Laffer on this issue on CNBC. He emphasized that sheer volume of these excess reserves and predicted dire consequences when banks decide to use them. I emphasized that the banks are holding them voluntarily, so they must think that they're needed. Attempts to remove them prematurely would probably trigger the same reaction as it did in the 1930s.

Laffer focused more on other kinds of policy mistakes made during the Depression, particularly raising taxes in the middle of the 1930s in order to balance the budget. I agree. That was also a huge mistake. In addition to bad monetary policy and bad fiscal policy in the 1930s, another huge mistake they made was a tilt toward protectionism by enacting the Smoot Hawley Tariff. That attracted retaliation and caused a worldwide contraction in world trade. We've been moving dangerously in that direction ourselves, first by abrogating the trucking provisions of NAFTA, and more recently with the tariff on Chinese tires of all things. If that starts up, it could get out of hand. And, lately, just about every major country has had a shrinkage in its international trade. Lately, our exports have been going down and our imports have been going down.

Turning to the economy, the recession began when employment started falling in January 2008. Last Friday, we learned that the employment loss for September was 265,000 jobs, which was much better than the peak monthly loss of 700,000, but was still higher than expected. The unemployment rate is now 9.8 percent and rising. I expect it to go over 10 percent in the next two or three months and stay there for a while. Even though employment is getting worse, it does look like that real gross national product is going to become positive in the next issue, in the third quarter that was just completed. In the first quarter, gross domestic product declined 6.4 percent, in the second quarter it declined 0.7 percent, and in the third quarter people are now guessing that it's going to go up to maybe 3 percent. The problem is the main reason it's going to go up is a reversal of inventory liquidation, an inventory rebound and cash for clunkers. That's hardly a sound basis for a sustainable recovery, so I worry that the fourth quarter will be weaker than the third.

The big fly in the ointment is the plight of the consumer whose spending makes up more than 70 percent of total GDP. Consumers used to think that their capital gains in real estate and in their 401(k) and their IRA were a substitute for savings. That would give them extra money that they could spend. The problem now is both of those things have turned from strong positives to strong negatives. Now consumers still need to save, but the only way to do so is to cut back on consumption. So, if consumers all do what they need to do, it will tank the economy. Keynes called that the "paradox of thrift." And, if consumption is weak, it's hard to imagine business investment picking up very much. So, I'm a little skeptical about the sustainability of a recovery at this point. If it is sustained, I think it'll be weak. Job losses will continue several more months and the unemployment rate will linger near 10 percent for a good while, in my opinion. Even if GDP rises, it's hard for me to call it a recovery as long as employment is declining.

Another policy issue is the dollar. The consensus is, on financial TV, that the dollar needs to strengthen soon. I disagree. A strong dollar is good for our standard of living in the long run, but

a stronger dollar right now would threaten our recovery in the short run. We need a competitive dollar right now to boost our exports-relative-to-imports. My position on a strong dollar is similar to St. Augustine's position on chastity. You remember his famous prayer: "Lord, make me chaste, just not yet." Lord, give us a strong dollar, but not just yet.

Financial reform is going very slowly and is focused on secondary issues like executive pay, for gosh sakes. The only thing to get at the cause of the crisis is a modest proposal that mortgage lenders keep a small portion of those loans on their own books (have them eat their own cooking). There will be some consolidation of banking agencies probably. And it looks like the rating agencies, though, are going to survive, although the government's stamp of approval may be watered down somewhat.

It looks as though the SEC and the Financial Accounting Standards Board, FASB will probably not be reigned in, despite their terrible performance over the last two years. A stand-alone consumer protection agency will probably be created and it may take an interest in insurance sales practices, as well as credit cards and commercial bank loan practices.

A big part of the crisis was mark-to-market accounting, which forced banks and I think insurance underwriters to write down ill-liquid assets to fire-sale prices. And that destroyed a lot of capital unnecessarily. Banks, and probably insurance companies, were holding securities backed by mortgages that eventually would come back up, maybe not all the way, but come back up. They were having to write them off, and every dollar of write-off was a dollar of lost regulatory capital. So, a lot of the bank failures probably could have been avoided.

Last March, I testified before a subcommittee of the House Financial Services Committee arguing for modifications in mark-to-market accounting. Those modifications were made on April 2nd. However, FASB did not make them retroactive. They said, "Well, we've got a cure for cancer but only new cancer patients need apply, even though it's going to be helpful and we're already seeing some better results from banks and from insurance companies because of some easing of those ridiculous mark-to-market requirements."

In summary, the economic recovery will be slow, but the consequences of the policy measures taken will not be as dire as a lot of the scaremongers say. I'm not heading for the hills. I'm not stocking up on ammunition or even buying gold.

Thank you very much. Time for questions.

Q. You gave out figures for unemployment. From data I have read, in one month July or August, the unemployment rate was excluding 600,000 or so people who were no longer being calculated because they ended their job search. They're still unemployed. The same thing: I think recently, 571,000 came off the rolls of the unemployed but are still unemployed. Secondly, what do you think the administration should do more of and what should they do less of?

A. On the employment numbers I gave, I gave the numbers as they have been given in recent years just for consistency. Certainly if people stop looking for a job and they're surveyed by the household survey, they're not counted as unemployed. They're just counted as outside the labor

force. And some people do stop looking for a job because they're discouraged and think there's no point. In reality, the effective unemployment rate is much higher than the official unemployment rate. Nobody ever mentions though, on the other hand, if you get a knock on the door and they ask you if you're in a job and you say no, and they say have you been looking in the last six weeks, you might say yes even if the answer is no. So I think the error probably works a little bit in both directions. But, net, I think you're right.

Normally extending unemployment insurance has a negative impact because it reduces the incentive to get out there and get a job. But that's true in normal times when there are jobs out there. In a circumstance like this where unemployment is so great and people are running out of their unemployment insurance, I think it's perfectly OK for them to extend it. Right now our unemployment has the greatest longevity I think in many years.

Now on Mr. Obama, what else could he do or not do? He ought to tell the world if he can't say we're going to keep the Bush tax cuts, at least say we're not going to let them expire during this recession. And there's one very important tax that he really ought to go ahead and lower. That's the business tax, which is the highest in the world.

Mr. Rangel, of all people, a year or so ago was talking about that. He may have lost some of his credibility on the tax issue lately, though.

Q. On a C-SPAN interview maybe about October last year, Representative Paul Kanjorski was talking about \$500 billion being snapped out of the economy within two hours. It almost caused a run on the banks that he estimated to be about \$5 trillion. I have not been able to see anything about this, find anything about this anywhere, although there has been some nuances about it in the news. Do you know anything about that?

A. No, I don't know what that's about. Sorry.

Q. With an exploding Federal budget deficit of \$1.6 trillion, I think that's the last number I read, unemployment continuing to spiral out of control, by all accounts a failed stimulus program of \$787 billion, what is your view about the current health care reform debate in creating another \$850 billion trillion (the number keeps bouncing all around) but, essentially, creating another spending program with the environment the way it is now?

A. I work for the National Center for Policy Analysis and I stay on the financial side of things. But, historically, they have spent most of their time on health issues, social security issues and retirement issues. They recently ran a petition online against government takeover of our health program and got 1.3 million signatures which they delivered to Congress on the day Congress returned. They delivered it in an ambulance, by the way. My organization is for free market approaches to health care and against further expansion of government involvement.

Q. Quick question about interest rates: I was intrigued with your comments with regard to inflation and, given the infusion that we're seeing of the spending, could you hazard a guess with regard to the interest rates 24 to 36 months out and, obviously, the corresponding impact on the housing market which we need to see recover?

A. Yes. Well, right now, there's been a lot of liquidity being pushed out there and everybody is scared to death, so they put their money in the safest things they can find, namely, Treasury securities. So interest rates are artificially low and they'll probably stay artificially low for some time. If we start getting signs of inflation, those interest rates on the long end will start up because of the inflation. On the other hand, if we start getting what looks like a healthy economy, they may start up as well on the long end, because it's not natural where they are now.

If we're talking about when the Fed might reverse its policy of super ease, I don't know the answer to that. One of the governors wrote an editorial in *the Wall Street Journal* the other day that tried to suggest that it might be sooner than most people think. Chairman Bernanke's comments still emphasize the mistake we would make if we ease too soon.

Where will interest rates be in two or three years? I'd say, because we will have a healthier economy in two or three years and maybe a little bit of inflation, they'll be higher than they are now. And that will be a good thing.

Q. What's it like dealing with the chairman of the House Finance Committee, Barney Frank?

A. Thankfully I don't know. The testimony I gave the other day was to a subcommittee of his committee, and he wasn't present. You might be interested to know that I was asked to do that because they saw me talking about mark-to-market accounting on CNBC. When my testimony started, the Republican ranking member on the House Banking Committee recommended my blog to all the other committee members and had one of them entered into the Congressional Record. And the blog he had entered into the Congressional Record was my mark-to-market nightmare. It was satire where I went on a vacation. I came back and all my bonds had been marked down, and I was broke. And I said, "Well, that can't be. I don't have to cash those bonds in, I can wait. No, can't do it." So that's what got me to testify.

I'd like to be able to say that I testified on a Thursday, FASB changed its policy on Monday and then two weeks later made them official. That would be true. The problem with that is the Congressmen had already gotten fed up with FASB and so all the Congressmen were on my side during that testimony and I was sort of redundant. I felt like a rooster who thought he'd brought the sunlight up.

Q. I've asked this question of our prominent speakers in the past, and I always found their answers quite intriguing. Given that we're financial advisors and are often asked to give advice to people on allocating assets, would you share with us your own personal allocation of your assets in percentages of course, over the different asset classes, how you've chosen to pick those and why?

A. Well I'm not proud of it. When I joined the Fed in 1968, the research director at the Richmond Fed said, "Look, this is the only advice you need about the stockmarket. The younger you are, the more you should be in stocks and, as you age, you should gradually switch from stocks to bonds." Now, I'm not going to tell you how old I am, but I should have a lot more bonds than I do.

A few years ago, I decided the dollar was going to work its way down and I way overloaded international mutual funds, mostly Fidelity because I had an account at Fidelity. And it worked perfectly. My portfolio of international mutual funds went up about twice as fast as my domestic mutual funds and my Fed 401(k). But, before any of those were realized, stocks started down and I learned that just as they went up twice as fast, they went down twice as fast. I didn't sell anything. I've ridden it all the way and I stayed with it and now I'm coming back up again. Since March 9, my portfolio is up 30 something percent. But up 30 something percent is not nearly as much as down 50 percent.

Q. I have two important questions: one is I heard on C-SPAN a Republican Alabama senator talking about a payroll tax holiday. I am surprised that that idea has not even yet surfaced, because the gap between offshore jobs and jobs in the U.S. is exactly the gap of the payroll tax and the benefits. So, if a business owner has a payroll tax holiday, it obviously creates an opportunity for him or her to hire more people. Secondly, the unemployment, I even tried to hire some folks and they said they would rather live on unemployment than work. It's creating an incentive for people not to work. The second part was there was a recent ruling that was passed. We as advisors are the best group, and especially the people in this room, to advise their clients how to deal with this crisis, and the regulatory authorities are tying us down by having all kinds of frivolous records on our checks, which doesn't make any sense. If someone goes with a frivolous lawsuit against you, it shouldn't be on your record, if it was closed and dismissed or didn't happen. The recent ruling is everything on there. It's not fair, it's not right.

A. I'm not smart enough to hold all of this in my head. On the last point we greatly need tort reform and we're not likely to get it. Texas had doctors moving out of the state because it was an easy state to get good high settlements on suits. They reformed and people are coming back. When you talk about health care, that ought to be the first thing you do. Then the next thing might be to allow competition for insurance across state lines.

Generally, on stimulus, if I had my druthers, I'd say do some supply-side tax cuts. Cut business tax. It's hard to explain to people, but wages depend on the demand for labor. The demand for labor depends on how much capital there is to work with labor. When productivity of labor goes up, it's almost always because there's more capital per worker. So, cutting taxes makes it more profitable to hire workers, will do more for employment and for wages than anything you do directly with wages.

Now in cutting the payroll tax, that would be easier to do than cutting a business tax in a Democratic administration. It looks fairer. It looks more like it's helping the people.

I think some people have suggested a temporary hiatus in the payroll tax as a means to stimulate employment. I would be for that, but that's a second-best solution.

Thank you very much.

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