

# The Low Down

## *Understanding the Credit Crisis*

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The United States is in the midst of what is certain to be both the worst and the most unique economic crisis in nearly 7 decades. The various economic “excesses” that collectively contributed to this crisis are steadily being uncovered and documented. This is progress in that economists, lawmakers and businesses must first gain an accurate understanding of the causes of the current economic crisis in order to design and apply the most efficient and effective medicine to successfully cure the ailment. The goal of this article is to summarize this new information into an overview of what happened, how it happened, why it has lingered so long. I will also explore some new plans of action that I feel have great potential.

Historically, financial crises generally occur at the hands of monetary excesses that create a boom and a corresponding bust. In the present crisis, the housing boom and bust – coupled with a failure in properly underwriting risk at several levels - led to a global credit crisis that in turn pushed most of the world into a deep recession.

Loose monetary policy by the Federal Reserve from 2000 to 2006 is what many believe was the *initial* trigger of crisis. Recall that in the early 2000s great concern was placed on fighting the possible onset of deflation, which had plagued Japan during most of the 1990s. To combat this fear in the United States the federal funds rate was lowered considerably. However, it was never returned to normal levels once the specific concern was removed, as was the typical Fed action since the early 1980s. What's more, several European countries, who tend to be influenced by and mirror U.S. policy, kept their interest rates equally low<sup>1</sup>.

Current data clearly indicates that these low levels in interest rates enabled the housing boom that led to the current bust. More specifically, those countries (especially the U.S., England, Ireland and Spain) whose federal funds rates deviated the *farthest* from historical regularities experienced both the largest boom and the largest bust in housing prices.<sup>1</sup>

The housing boom quickly gained exponential steam in this low interest rate environment as interest-only and adjustable-rate mortgages made houses far more affordable for Main Street in the short term. An equivalent appetite of lenders led to sub-prime lending--lending to less-than-prime borrowers (based on inadequate credit scores, income and other criteria) who may not be able to afford a home long term, especially if interest rates returned to normal levels. All of these factors significantly expanded the

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<sup>1</sup> The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong, Written version of keynote at Bank of Canada, November 2008

audience for home buying (demand) which naturally increased prices significantly. As home prices rose, handsome profits materialized for many home buyers, and this in turn fueled larger subsequent investments and attracted new investors in a phenomenon often labeled “herding behavior”.

At the same time equal excesses were being felt, and encouraged, by Wall Street. The world was awash with capital and an intense demand for more yield. Many investors, including charities and endowments, began investing a far higher percent of their capital into higher yielding exotic investments through hedge funds, as opposed to their typical main staples of stocks and bonds. Slick new securitization methods emerged involving the dissection of a bundle of loans into several separate tranches (based on varying credit risk). In this model, the loan payments of the entire bundle of loans first go towards paying out the first tranche portion of the bundle *in full* before resources are then applied to paying *in full* the next tranche in line, and so on. This method simulates less risk and pays a lower return to the higher priority tranches. Tranches of lower priority and greater risk receive higher returns. This popular method allowed investors to more specifically select their risk/reward tolerances which further fed the vast demand to deploy capital and an equal thirst to borrow.

The sheer number of loans involved in these various pools of securities encouraged a decoupling of the lender, underwriter and the parties that ultimately ended up with the pools of loans and thus the underlying risk. Further, as the popularity of these securitized vehicles grew, it became challenging to locate additional borrowers. Thus market forces further distorted the questionable practices and incentives by the parties creating the pools of loan, the mortgage brokers and the appraisers.

This vast availability of credit, coupled with the low interest rate environment outlined above, flooded the market with cheap and readily available capital. This abundance of capital led to further increases in demand for real estate creating higher prices, which in turn led to even higher demand. The expectation became that the sheer passage of time alone would enable the real estate buyer to re-sell for a sizable return.<sup>2</sup> This hunger by individuals to buy more real estate using more leverage fueled an upward price spiral that ultimately created one of the largest residential housing bubbles in our history.

The enormous appreciation in home prices combined with cheap and plentiful debt spurred an unprecedented sense of wealth, re-financing of equity and subsequent spending that ultimately outpaced many consumer’s ability to maintain spending at such high levels and to repay borrowings. Once these cracks in the economy began to appear, fundamental flaws became evident in the mathematical models that attempted to control risk in these securitized tranches--namely the flawed assumption that large-scale *nationwide* real estate price declines could not occur in these highly diversified pools. It was assumed that much, if not all, of the underlying home values would be preserved beyond the loan amount in a foreclosure event. Rating agencies failed with similar assumptions when issuing credit ratings for these tranches of debt. This

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<sup>2</sup> The Kitces Report, October 2008

assumption proved wrong as the U.S. experienced its *first* nationwide drop in home prices since the Great Depression. Wall Street had, in essence, been “turning lead into gold.”<sup>3</sup>

What’s more, the hunger for yield by so many of these investment groups led to the use of more and more leverage to boost returns. These players routinely succumbed to the pressures of “Benchmarking.” Benchmarking has been described as a prisoner’s dilemma created when those who leveraged the most posted higher yields that then became the new benchmark returns sought by investors in the marketplace. Operators therefore strived towards these target returns in order to be competitive in attracting and retaining investor capital.<sup>4</sup> Given these high levels of leverage, the initial defaults that occurred in 2007 were enough to prove fatal to several hedge funds that borrowed (in many cases, up to 30 and 40 times or a 97 to 98 percent loan-to-value) to buy securitized investments in hopes of earning a tremendous spread. It is easy to see how even a small downward movement in value could completely wipe all equity with these levels of leverage.

In 2008, catastrophic losses in these securitized assets ultimately spurred widespread deleveraging (of both good assets and these questionable assets) in a manner described by many as “fire-selling.” Balance-sheet leverage ratio requirements, coupled with mark-to-market accounting rules cause most of these institutions to repeatedly readjust their balance sheet calculations based on the latest fire-sale ‘comps’ to hit the market. This in turn feeds further fire-selling, which is where the situation remains today.

How did all of these bad mortgages and complex derivatives or so called “Toxic Assets” held by Wall Street led to a global credit crisis that in turn crippled an already wounded Main Street? The answer is what changed in the *traditional interbank lending* climate. The following description of this credit cessation was offered in a report published by Horace Brock of Strategic Economic Decisions:

“As we understand it, some twenty or so global financial institutions constitute the critical nexus of the world’s entire financial system. Not only do these behemoths need to rely on one another, but so do a wide range of smaller banks need to cease to be able to rely on their big brothers to carry on their day to day business as usual. The essence of interbank lending lies in the need and ability for the large banks to be able to lend to and borrow from one another at virtually anytime they need to. The time span of such loans/borrowings can range from a few days to a few weeks, or even months. When a given bank has surplus funds, it profits by lending them out. When it needs funding to meet obligations, the same bank must be able to obtain such funds at the best price. Note that since all banks are in this position of having to sometimes lend and sometimes borrow, it is thus in the interest of all

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<sup>3</sup> The Kitces Report, October 2008

<sup>4</sup> Strategic Economic Decisions, The Global financial and economic Crisis, December 11, 2008

of them that the merry-go-round never stop. If the system freezes up and does come to a halt, then banks big and small seize up everywhere, and the supply of credit stops flowing to Main Street.”<sup>5</sup>

Under this scenario loans typically available for consumers and businesses are suddenly no longer available.

The next important piece of the puzzle to understand is why this interbank lending halted. Almost all of these banking giants (and many small banks as well) placed large investments in the securitized loan pools described at the beginning of this article and/or issued complex derivative instruments<sup>6</sup> - now commonly referred to as “Toxic Assets.” The value of these pools of toxic paper and derivatives continued to worsen as the crisis lingered on. Balance sheets of these banks are deteriorating with astonishing rapidity and no one knows where the value of these assets will finally settle. For perspective on how rapidly these assets were being devalued, the government’s estimation of the cost to bail out AIG (a large holder of derivatives insuring these loan pools) started at \$15 billion and ended up at \$85 billion just four days later. To muddy the waters further, the government’s decision to allow Lehman Brothers to fail while coming to the rescue of others created vast uncertainty when it came to predicting Treasury-Fed intervention and the security of any *one* bank. As a result, the *counterparty risk* of lending to Bank A becomes too high for Bank B to bet its precious surplus funds on. Suddenly interbank lending screeched to a halt.

The final topic of this article is to discuss the measures initially taken by the Federal Reserve, Treasury Department and lawmakers. More specifically, it is now evident that the actions initially taken by lawmakers were not effective cures given what we now understand about the crisis. Finally, I will discuss what many are suggesting to be the appropriate line of action going forward.

Initially, three actions taken by the government focused on “liquidity” or adding dollars to the system. These included lowering the federal funds rate, cash infusions in the form of checks to households and the formation of Term Auction Facility (a new way for banks to borrow from the Fed rather than going to the discount window). Historically, these are the sound methods to fight a recession. However, these methods address liquidity and not the most significant problem in the capital markets today-- “counterparty risk”, as described above.

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<sup>5</sup> Strategic Economic Decisions, The Global financial and economic Crisis, December 11, 2008

<sup>6</sup> Derivatives are intangibles like insurance, puts, calls and in this case guarantees on the performance/collectability of these pools of loans. Many securitized pools of loans were sold with insurance or guarantees to increase their value and reduce their risk. In many cases tranches were resold from one investor to another with the seller adding a guarantee an additional price. To make matters more tangled these guarantees were sometimes resold to subsequent investors removing the seller from their previous guarantee. As a result the task of tracking down the holder of these derivatives and assessing their ability to cover the cost of losses complicates the process of valuing the mounds of toxic paper in the market.

Unfortunately, many theorize that these liquidity tools devalued the dollar, which spurred the drastic spike in oil and commodity prices that worsened the economy. Fortunately, commodity prices have since subsided as it became apparent much of the world was in a deep recession and globally spending was being significantly curbed.

The first action targeting counterparty risk was discussed during the passage of TARP (Troubled Asset Relief Program) which seemed to improve matters somewhat. However, ultimately these funds were not utilized to reduce risk by removing toxic paper from the banking system. International pressure from other central bankers (namely England and France) to simply infuse the banks with cash, coupled with difficulties in appropriately valuing these bad assets proved too challenging. As a result, the 1<sup>st</sup> half of the TARP funds were utilized to provide more liquidity directly to the banks.

The strategy that I believe is most sound and one that began to gain ground (when this article was written on January 19<sup>th</sup>) is the “Good Bank / Bad Bank” concept. Recognition is growing that bad assets must somehow be purged from banks’ balance sheets before they will freely make new loans and thus, thaw the credit market from its deep freeze<sup>7</sup>. The government is now pondering the formation of a “Bad Bank” which would purchase the toxic assets that are causing enormous losses and feeding further deleveraging. By removing these assets from the balance sheets of the “Good Banks” that remain, the risk in interbank lending transactions is greatly reduced. Thus, interbank lending is encouraged. The Bad Bank could then patiently and properly value the remaining toxic assets and package and sell such assets on the market. With the problematic loans, they could ultimately choose to renegotiate, foreclose or sell those loans—all with a more accurate understanding of the true value of the homes serving to collateralize the loans. Through this process, the government should end up with far more capital than with the current methods of infusing money into banks for a stake in ownership. Placing the task of shedding these toxic assets onto banks leads to reactionary fire-selling and simply does not create the environment necessary to realize the fullest value of the assets.

Another consideration (though it may not be as necessary with the Good Bank / Bad Bank strategy above) would be to revise mark-to-market accounting rules so as to allow these pools of loans to be valued based on their underlying asset value – the homes – instead of the price an investor would pay short-term for the entire portfolio. Without a dollar spent this could theoretically reduce the fire-sale deleveraging (as required to comply with our system’s balance sheet leverage ratio requirements) that is feeding bank losses.

The initial actions by the new administration in Washington will be vital. Another round of cash infusion checks to households would be a total waste in the goal of getting credit flowing in the banking system and down to the consumer. We simply do not have funds to spare if the appropriate strategy involves placing a ring-fence around the problematic assets. President Obama is certainly not short on talented advisors such

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<sup>7</sup> The Economist, January 17, 2009

as Warren Buffett. Obama has proven to be a good listener, but he may have talked too much about stimulus checks to now abandon the action.

One thing has certainly improved, and that is the understanding of the specific forces fueling the crisis. With this in hand I am hopeful lawmakers and the new administration can get credit flowing again on Wall Street and on Main Street. However, with the rampant spending levels experienced from the 1980's to recent times, most consumers have tapped-out their credit cards and home equity. Further, this current recession has startled consumers and evoked a great amount of fear. It is unknown whether this fear and lack of further means to credit will result in a significant and lasting shift in consumer behavior towards more prudent spending and saving levels, or whether a *new* means will emerge to return the U.S. economy to a massively leveraged consumer-based economy.

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