On October 7, 2008, five faculty members from the economics and finance departments of the University of Tampa held a panel discussion on the economic crisis that was open to students, faculty, and staff. Each panel member provided opening remarks to lay the foundation for questions from the audience. Although the event was well attended with about 175 individuals present, the panel wanted to make their remarks available to a wider audience. This newsletter is an attempt to do that. We hope you find this information useful in evaluating the current state of the economy. If you have questions, please feel free to contact the faculty members directly or myself.
I’d like to discuss two matters in this essay. First, I’ll highlight a few of the parallels between today’s crisis and the Great Depression. Second, I will suggest that imposing more, or even different, regulation on the financial market is not always a cure-all to a financial crisis.

First, let’s think about the Great Depression. As Amity Shlaes reminds us, the stock market crash of October 1929 and the Great Depression were not the same thing. One thing that made the depression great is its duration – the fact that unemployment was still 20% ten years later in 1939. Although the U.S. economy is not yet in a recession, it’s interesting to look for similarities between today and 1929. Not long after the Dow’s 47% crash – to 199 points – at the end of the summer of 1929, President Hoover – like our own SEC chairman Christopher Cox – stopped short sales in the financial market. Short sales are essentially contracts to deliver something in the future, which a person does not own. Remember that “shorts” are common to many types of businesses. For example, when a builder contracts to build a bridge he is literally short of all material needed to build the bridge. But we still think the short to build a bridge is a productive contract. Thus, it is useful to think of short sellers as a canary in the coal mine – letting everybody know when things are starting to die. Bottom line: you want short sellers around – they reveal very important information.

By the summer of 1932, the Dow dropped another 75% – to the 50s range – or 87% from its high of 381. (On October 10, 2008, the Dow closed down 38% from its all time high.) Three years after the 1929 crash, Hoover created the Reconstruction Finance Corporation. Hank Paulson, the Secretary of the Treasury, has modeled his Troubled Asset Relief Program (TARP) after Hoover’s Reconstruction Finance Corporation. Ultimately, the Reconstruction Finance Corporation un-clogged asset markets by providing liquidity to the market. It is hoped that a similar result occurs in the current crisis.

Mark-to-market regulation created a virtuous cycle for investment banks on the way up, but a vicious cycle for the whole financial system on the way down.

So what else made the Great Depression great? Many believe that subsequent bad public policies had a lot to do with the painfully slow recovery. Examples include bad monetary policy and a large dose of market regulation. Indeed, let us not forget that Fannie Mae, one source of today’s “toxic debt,” was a government institution created by FDR in 1938 as a response to a “market failure”.

The second matter that I want to discuss is “Mark-to-Market” regulation. During the 1980s, loans made by S&Ls were recorded on the books equal to the value at the date of the transaction. The book value would only change if it was sold or became impaired. After the S&L crisis in the 1980s, regulators argued that traditional accounting regulations allowed banks to “hide” bad assets on their books. John Berlau reminds us that, at the time, it was argued that assets needed to be valued on what they would trade for in a market today. Thus, mark-to-market regulation was born as a substitute to the regulation that existed during the S&L crisis.

While the real estate sector was booming, mark-to-market regulation essentially increased the value of the assets on everyone’s books – allowing investment banks to leverage even more than under the old regulation that was around during the S&L crisis. However, as the real estate market contracted, highly leveraged investment banks had to sell assets at a steep discount to maintain their “financial capital” requirements, which are regulated by the government. Thus, because of asset fire sales, the “market price” of investment banks’ assets had to decrease across the board – even if investment banks planned to hold their mortgages to maturity. Mark-to-market regulation created a virtuous cycle for investment banks on the way up, but a vicious cycle for the whole financial system on the way down.

My point is that mark-to-market was a regulation imposed to stop a second S&L crisis, however, it in fact might have contributed to another financial crisis. So, in the end, be careful of what you wish for – the unintended consequences of regulation sometimes swamp its intended benefits.
If I were to identify a few key factors that have led us to our current “state of the economy” as is being characterized by the recent failure of a few large (and high profile) financial institutions, I would specify (1) “good intended – but poorly thought through” – government regulations, (2) a prolonged intervention of the Fed (a government institution) to prevent a recession in the early 2000s – maintaining interest rates at especially low levels, and (3) behavior by some from the “for profit” side of the financial markets that is predictable in the context of the assumed promise from government to protect us from the consequences of our own poor decisions. On October 2, 2008, George Mason University economist (and syndicated columnist) Walter Williams said (with regard to the government’s then proposed stock market bailout bill) “These problems were caused by the government…” (and) “…if you see a building on fire you do not call the arsonist who caused the fire (for help).”

Over the past few decades, Congress has passed laws and amended regulations to encourage (increase from equilibrium) home ownership – such as the Community Reinvestment Act (1977). This particular piece of legislation strongly encourages (through regulation) lenders of private financial institutions to make loans to low-income parties who are unlikely to be able to pay them back. In effect this discourages the restriction of financial instruments from select parts of a bank’s market – a procedure that has gotten a great deal of press under the name “redlining.” Freddie Mac and Fannie Mae (quasi-government enterprises themselves) guaranteed such risky loans – they were able (with lower reserve requirements than their purely private equivalents) to absorb them upon need. The intention of these laws and regulations was to make available to more Americans the “benefits of home ownership” – a “wonder” that this economist has yet to enjoy. Though nobly intended, as is often the case with well-intended regulations, there are often unintended consequences.

It is reasonable to assume that policymakers will approach the American taxpayer again (with hat in hand) in the next 4 months asking for another “emergency market supplement.”

Today the market is peppered with financial institutions that possess portfolios too heavily populated with “sour assets” – either financed by individuals unable/unwilling to make good on their investment or (as a result of the housing bubble burst of the last few years) valued significantly less than the mortgage attached to them. The options we faced during the first week of October (before Congress passed a revised bill through both houses) were do nothing or intervene. Looking the other way and letting the market self correct would have reallocated the scarce human, physical, and financial capital in the market to its highest (“best”) use away from its current – flawed – use; this misallocation of our scarce resources is reflected in the falling share values of the financial entities that have facilitated them. As Dan Mitchell (of the CATO institute) said recently about the need to let markets self correct – “Capitalism without bankruptcy (or losses) is like religion without hell.”

Government intervention, though, reinforces the belief in the market that poor decisions by decision makers in private firms will be “bailed out” – bailed out, I might add, with loans from future taxpayers – such as UT’s current students – that are unlikely to be fulfilled. After all, market investors are only willing to pay a small portion on the dollar to assume the responsibilities of these firms, a clear signal that such loans are not reasonable to extend.

Finally, government intervention also penalizes (implicitly) the common sense lending behavior of firms who did not respond to either the regulators “carrot and stick” or the temptation of the especially low interest rates that existed in the midst of the housing boom earlier this decade; the firms that did not encumber themselves with these risky investments accepted smaller markets and smaller potential returns.

Finally, there is the full cost of the government’s “solution” to a problem of its own making. The so-called continued on page 7
Defining Crisis in the Banking System

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Though there are myriad issues under debate regarding the current financial crisis, nearly everyone agrees that it is, in fact, a “crisis”. What is meant by crisis, however, differs among pundits, politicians and economists alike. Economic game theory provides a useful definition of crisis which addresses the severity and systemic nature of the problem. This definition is supported by the empirical evidence which indicates that the U.S., and perhaps much of the world, is suffering from this type of crisis.

Dictionary definitions of crisis range from the relatively benign – a “decisive moment” – to the more malignant – a “paroxysmal attack of pain, distress, or disordered function”. The latter definition, implying as it does convulsion and dysfunction, better characterizes the current financial state. Convulsion accurately describes the rapid freezing up of the credit markets in which many companies, individuals, and banks have been unable to borrow. Dysfunction is evident from the impotence of traditional tools of monetary policy and the paralysis that persists in the banking system.

To understand the theory behind crisis, consider the usual monetary policy prescriptions for a slowing economy. To stimulate the economy, the Federal Reserve “loosens” monetary policy by lowering both the interest rate at which banks loan to one another (the federal funds rate) and the rate at which banks can borrow directly from the Fed (the discount rate). Lower interest rates and low-cost loans from the Fed make bank lending more profitable. A single loan issued has a multiplier effect throughout the banking system which enlarges the money supply, increases deposits, generates more loans, and stimulates the economy. Though no banker would say that he or she creates money, each one unintentionally contributes to the money creation process.

Now imagine bankers are overcome with fear. Fear that commercial and real estate loans will default. Fear that depositors will withdraw their savings. Fear that fellow banks won’t repay interbank loans. Even fear that their own assets, many of which are backed by subprime mortgages, will become worthless. Under these conditions, banks have incentives to decrease their loans and hoard cash to protect their own balance sheets. The very loans which provided profits for banks and collectively bolstered the banking system now appear hazardous to an individual bank.

The commercial paper market has declined from $2.3 trillion in mid-2007 to $1.8 trillion in December 2007 and literally seized-up in September 2008.

Such market dysfunction was articulated by the Nobel-prize winning mathematician John Nash. The key insight of Nash was that rational behavior at the individual level might lead to irrational outcomes in aggregate. To illustrate, consider a game played among bankers called Loan or Don’t Loan. If all banks loan, the system functions properly and all players are better off. If no banks loan, the system dysfunctions and all are worse off. If only one bank loans, and herein lies the rub, that bank increases its likelihood of failure from which the remaining banks may actually gain market share or benefit from a fire-sale purchase. Under this scenario, the optimal strategy in the game of Loan or Don’t Loan is don’t loan.

The failure of monetary policy to loosen credit and thus stem the dysfunction supports this thesis. Between August of 2007 and mid-October 2008, the Fed has lowered the federal funds and discount rates by 3.75% and 4.50%, respectively, offered loans to nontraditional banks while significantly lowering collateral requirements. Unfortunately, many banks initially shunned borrowing from the Fed, lest they appear insolvent and scare investors into dumping bank stock. Those who have borrowed have kept the funds as excess reserves to shore up their capital rather than making loans. Even worse, the Fed’s ability to control the tools themselves has failed. For example, the federal funds rate, controlled on a daily basis through the Fed’s ability to increase and decrease reserves in the banking system, has deviated wildly from its 1.5% target rate. The effective rate has exceeded 8% more than 5 times in the past year. On September 30, the day after Congress voted down the Rescue package, the federal funds rate hit 10%. This meant that banks were so wary of lending to each other overnight that they required a

continued on page 7
The key underlying cause of our current market disruption is the precipitous decline in residential real estate values. The Case/Shiller index at the end of Quarter 2, 2008 was down 18% from its 2006 peak; Shiller says he believes US real estate is still significantly overvalued. Economist Martin Feldstein wrote on October 4, 2008, in the Wall Street Journal that ‘experts’ he talks to say real estate is down 20% with 10-15% more to go in this correction.

A decline in real estate prices causing economic suffering is not unusual; real estate development and speculation is usually a boom/bust industry, so how is today’s bust different? Compare our recent troubles to the real estate bust and savings and loan crisis in the 1980s: it was regional in nature, but also restricted to mostly thrift institutions (especially S&Ls), developers and investors, some insurance companies, a few pension plans; only a few major commercial banks went bust, and investment houses or other industries were not much affected. Massive securitization of mortgage debt is the source of the difference. Due to the securitization of mortgages into mortgage backed securities (MBS), now there is contagion to commercial banks, investment banks, insurance companies, government investment funds, mutual funds, even money market funds. (Note: some have argued hedge funds have escaped; not so. Hedge funds in the MBS business were among the first to fail (at Bear Stearns, for example); they were an early warning signal. Nimble by design, most other hedge funds simply exited MBS strategies to focus elsewhere.)

Securitization became a global trend, so the same interlocking structure between real estate and the financial system now exists elsewhere.

Fragmentation of the mortgage business has been going on for decades. Loan origination, loan servicing, and loan funding (investors) have been increasingly done by different firms. The government, through its various housing programs and government sponsored enterprises (GSEs) has been encouraging and rewarding this fragmentation. These GSEs include FNMA (created in 1938, stockholder-owned since 1968, now called Fannie Mae), FHLMC (Freddie Mac, 1970), and FAMC (Farmer Mac, 1988), and they have all played a role in increasing securitization, which separates the funding (investing) of mortgages from origination and servicing. In addition, fully-private operators (such as Countrywide, which was recently taken over by Bank of America) now participate in MBS issuance and investing.

MBS were initially fairly simple pass-through instruments, but faced more valuation uncertainty than most bonds because of both default and pre-payment risk. In part to increase marketability, these have been succeeded by increasingly complex bonds that allow customers to select from a variety of risk-return profiles.

The now-privatized GSEs and private operators, guided by the profit motive, have worked to increase market share (percent of all mortgages securitized) and the size of the market (total of all mortgage loans made) by aggressively seeking to make mortgage loans and to securitize them by, among other things, relaxing underwriting standards. At the same time, congressional oversight ignored the risk and rewarded all efforts to expand the marketplace to “less fortunate” borrowers. At the same time, bond ratings agencies appeared to fall asleep at the wheel in evaluating the risk of MBS in an increasingly overvalued real estate market deep into a long economic expansion. These all contributed to a speculative bubble in real estate prices, where investors purchased properties at high prices without regard to cash flow but in anticipation of further values. Continued on page 8

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ECONOMIC SPECIAL REPORT
Overview of Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008 (EESA) is intended to remove toxic assets from the balance sheets of financial institutions so that the credit markets can begin to function efficiently and spur economic growth. EESA authorizes the Secretary of the Treasury to buy toxic assets off the balance sheets of financial institutions. The uncertainty of quality of these assets has made the financial institutions hesitant to lend leading to decreased liquidity and increased volatility in our money and capital markets. EESA funds up to $700 billion for the purchase of these assets. $250 billion is given to the Treasury immediately to begin purchasing these assets. Once these funds are used the President can approve another $100 billion and then another $350 billion if needed.

The purchase of toxic assets will be handled through the Troubled Asset Relief Program (TARP) by the Office of Financial Stability established within the Treasury Department. The Treasury Secretary will also establish a program with adequate risk-based premiums to guarantee the troubled assets of financial institutions. The Financial Stability Oversight Board will review the actions of the Treasury Secretary to verify that they are in the interest of taxpayers and the American economy. The Treasury Secretary is required to make monthly reports to Congress beginning in two months. For every tranche of $50 billion in asset purchases the Treasury Secretary will provide detailed information about the terms of every transaction. Any future profits from the sales of assets purchased under the TARP will be used to pay down the national debt.

The Treasury will receive non-voting warrants from participating institutions so that the taxpayers can benefit from the growth in these institutions.

Mortgages and mortgage-backed securities purchased through the TARP must implement a plan to reduce the amount of foreclosures. Mortgage service providers will be encouraged to modify loan terms to minimize foreclosures while still considering the net present value to homeowners. EESA helps homeowners by expanding eligibility for the HOPE for Homeowners program through the Department of Housing and Urban Development. EESA also restricts executive compensation for institutions participating in the program by selling more than $300 million in assets to the Treasury.

Participating institutions must pay a 20% excise tax on golden parachutes and the tax deductibility is limited to $500,000 in compensation.

EESA also has a number of other provisions. The Treasury Secretary is required to coordinate with foreign agencies to establish similar programs. The Treasury will receive non-voting warrants from participating institutions so that the taxpayers can benefit from the growth of these institutions. The President is required to introduce legislation to limit losses faced by taxpayers. EESA establishes the Office of the Special Inspector General to audit TARP and to provide quarterly reports to Congress summarizing the Treasury Secretary’s activities under the TARP. A Congressional Oversight Panel including five outside experts will be established to provide monthly reports on the markets, regulations, and use of TARP. The Federal Reserve is given the ability to pay interest on reserves and must report to Congress its use of emergency lending. The SEC is authorized to suspend mark-to-market accounting (FASB 157) if needed and to conduct a study on the impact of FASB 157 within 90 days.
“Wooden Arrow” stock market bailout bill that passed through Congress is being represented as a $700 billion dollar bill. In fact, the total cost of this bill (after Congress sweetened the original language to pick up the needed votes to pass it) has been estimated to total over $1 trillion – according to Economist (and Senior Fellow from CATO) Dan Mitchell. Added to the bill after its original non-passage – and not directly related to solving the financial market problem – were tax cut “extenders” (extensions of the so-called “Bush tax cuts” that do not include off-setting reductions in spending to make them tax revenue neutral), “new-energy” tax credits (to hide the high cost of alternative sources of energy and make them more palatable in the market), a preferential tax treatment for NASCAR, and a now infamous tax cut on the manufactures of wooden arrows (as opposed to synthetic or metal arrows). Add to this the note by many financial experts that the current bill may not be enough to even sufficiently slow the market correction to come and you can put aside the possibility that it will simply “go away.” It is reasonable to assume that policy makers will approach the American taxpayer again (with hat in hand) in the next 4 months asking for another “emergency market supplement.”

I am known, among my students, for the mantra “without cost there is no change.” If we want to meaningfully impact the behavior of future decision makers in the financial institutions that we take for granted in our economy then we should let markets function as they were designed – rewarding those who follow reasonable policies that protect the assets of their shareholders / depositors and penalizing those who do not. Anything short of this approach – such as thoughtful regulation – relies on the good intentions of those not in the business to know what is reasonable (our policy makers) instead of depending on the experience of those whose job and, without further intervention, livelihood it is to know.

"Wooden Arrow" stock market bailout bill that passed through Congress is being represented as a $700 billion dollar bill. In fact, the total cost of this bill (after Congress sweetened the original language to pick up the needed votes to pass it) has been estimated to total over $1 trillion – according to Economist (and Senior Fellow from CATO) Dan Mitchell. Added to the bill after its original non-passage – and not directly related to solving the financial market problem – were tax cut “extenders” (extensions of the so-called “Bush tax cuts” that do not include off-setting reductions in spending to make them tax revenue neutral), “new-energy” tax credits (to hide the high cost of alternative sources of energy and make them more palatable in the market), a preferential tax treatment for NASCAR, and a now infamous tax cut on the manufactures of wooden arrows (as opposed to synthetic or metal arrows). Add to this the note by many financial experts that the current bill may not be enough to even sufficiently slow the market correction to come and you can put aside the possibility that it will simply “go away.” It is reasonable to assume that policy makers will approach the American taxpayer again (with hat in hand) in the next 4 months asking for another “emergency market supplement.”

When Franklin Delano Roosevelt uttered the phrase “The only thing we have to fear is fear itself” the U.S. was undergoing systemic bank failures. Fear within the financial industry has returned and is causing system-wide failure today. Governments and central banks around the world have responded with massive coordinated intervention. Let us hope that the very intervention some argue harms free market capitalism will help revive it.

lending premium four times as large as the stated rate itself. Evidence of dysfunction is also clear from the government bond market where panic spread so wide that the return on 7-day Treasury bonds fell to 0.05%. No doubt, many of these bond purchases came out of the very discount loans the Fed hoped would be used to stimulate bank lending.

The credit convulsion within the system came, in part, from outside it in what is known as the shadow banking sector. This sector consists of investment banks, hedge funds, commercial paper and other non-traditional funding sources. According to analysts at the Bank of Scotland, the sector is very large and accounts for half of all new credit creation in the last two years. Because these institutions don’t have the 10-to-1 leverage ratio regulations of traditional banks, they are able to invest more money against less capital. Investment banks often maintained a 30-to-1 ratio while hedge funds had an 85-to-1 ratio. This implies that every $1 of funding could be used to support $85 of mortgage lending. Like the banks, these institutions purchased mortgage-backed securities whose value has declined. Even worse, the sector is shrinking faster than it grew. The commercial paper market has declined from $2.3 trillion in mid-2007 to $1.8 trillion in December 2007 and literally seized-up in September 2008. Lenders in this market, money market mutual funds, experienced runs on their deposits to such an extent that the fund shares actually fell below $1.
price increases and quick profits. The relaxed underwriting standards allowed speculators to purchase many properties with little or no money down despite an absence of income or assets to secure the loans. Appraisal methods based on ‘comparable sales’ are not an effective protection against this type of market failure.

All this led to enormous growth in the MBS market, to a total of MBS outstanding of $6.1 trillion (US) by 2006, representing about half of all residential mortgages. Add in credit default swaps and other derivatives and it takes the total far higher. As of this year, FNMA alone holds over $400 billion in mortgage loans, with over $200 million in MBS outstanding, Freddie Mac holds about $750 billion in loans and MBS, and has about $1.8 trillion in mortgage guarantees outstanding.

As real estate prices finally began their inevitable decline over the past 2 years, defaults have increased, pressuring bond holders and issuers of mortgage insurance and credit swaps, with mark-to-market accounting putting pressure on bank capital ratios, and balance sheet contraction further drying up any demand for MBS and further fueling the downward spiral in prices. Contagion, fear, and panic have ensued, and that is where we are today.

There are global implications of the crisis. One might ask: How did US residential real estate values become a global crisis? First, many of the MBS issued in the US are held by global investors. Many investors viewed Fannie Mae and Freddie Mac bonds as substitutes for risk-free Treasuries, only with higher yields. Plus, securitization became a global trend, so the same interlocking structure between real estate and the financial system now exists elsewhere. And the speculation in US real estate was followed by feverish real estate investing in other parts of the world. Markets such as Macao, Dubai and even London that as recently as last year were setting records now look to be weakening as global credit dries up, and so the cycle of defaults, write downs and balance sheet contraction may now continue for some time overseas. ✪

Princeton Review Names UT College of Business One of World’s Best

For the third year in a row, The University of Tampa John H. Sykes College of Business has been named by The Princeton Review as an outstanding business school – and one of the 296 best business schools in the world. In The University of Tampa write up, students are quoted as saying that “teamwork and leadership skills” are “the focus of this MBA program,” and that professors here “have a genuine interest in students’ success and academic endeavors.” Students also praise the “beautiful campus” with “state-of-the-art facilities.” Dr. Frank Ghannadian, Dean of the College of Business, said students at UT are successful in that they have ample opportunities to mix classroom work with real world business application. “The College of Business is renowned for graduating students who are well prepared to make immediate impacts in the business community,” Ghannadian said. ✪