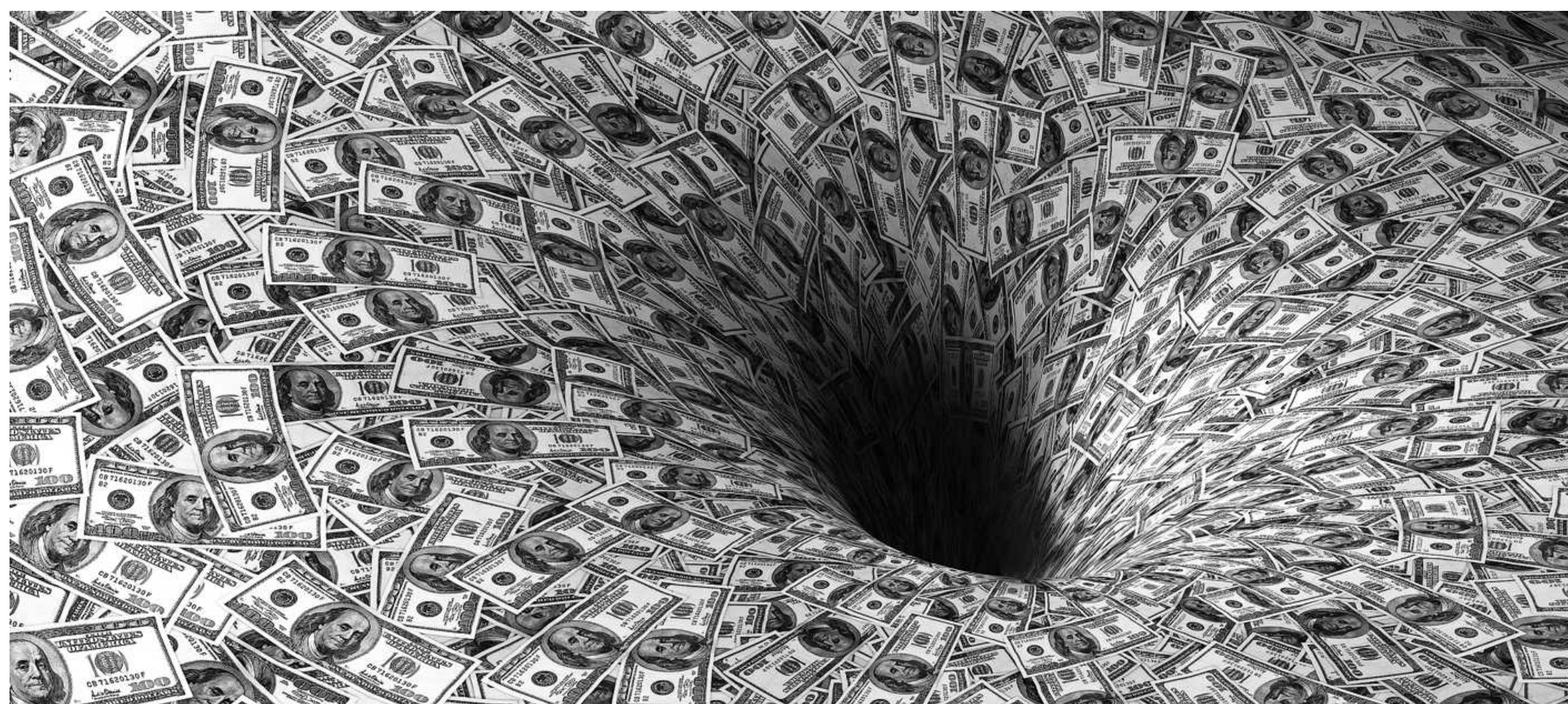
ON THE MONEY



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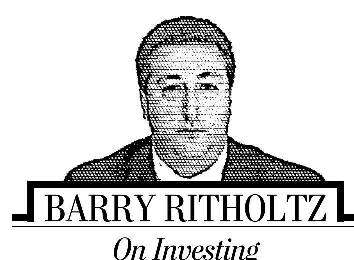
10 lessons on the crisis beyond the debt ceiling



BARRY RITHOLTZ
On Investing

The debt ceiling is hanging heavy over our heads. But that's not the only reason it looks dark down here. We've got some major and prolonged challenges: ongoing debt issues, structural unemployment, a housing overhang and continued economic frailty.

How did we get here? Well, by way of a financial crisis, stock market collapse, bank bailouts and, of course, the Great Recession — and a good many moments of poor judgment.

Given the drama of the debt-ceiling debate, this is a good moment for investors and policymakers alike to look back over the past decade at the mistakes made by our institutions, private sector and government.

If this were a college final exam, it would be in essay form. But because it's summer, and most of you are out of school, consider this the answer key to that exam.

1 Rates: After the dot-com implosion and 2000 market crash, the Federal Reserve lowered rates to 2 percent for three years, including a 1 percent rate for more than a year. That monetary policy was unprecedented. It had an enormous impact on various asset classes, including dollars, real estate, bonds, oil and gold. A more "traditional" interest rate between 4 and 6 percent would likely not have started the inflationary spiral we saw in commodities during the 2000s. Had rates been "normal," it is doubtful we would have seen a 41 percent drop in the dollar from 2001 to 2008.

2 The rating agencies: Moody's Investors Service, Standard & Poor's and Fitch Ratings — all originally served bond investors, who paid for their research. But that model changed in the 1990s to one that was funded by the syndicators and underwriter of structured financial products such as mortgage-backed securities. Essentially, bankers "purchased" the rating they desired. As a result, the performance of the rating agencies decayed, as they were no longer judged on the quality of their analytical reviews. Second, the underwriting quality of syndicators fell, as they —not a neutral third party — were, in effect, picking their own credit ratings. The real question for the financial markets is why we even require rating agencies to evaluate complex financial products any more.

3 The radical deregulation of derivatives: The Commodity Futures Modernization Act of 2000 was a highly unusual piece of deregulatory legislation. It created a new world of uniquely self-regulated financial instruments — the credit derivative. Unlike traditional financial instruments — bonds, stocks, futures, options, mutual funds — it did not require anything from underwriters or traders. No reserve requirements against future obligations, no counter-party disclosure, no exchange trading needed, no capital minimums. This had an enormous impact on risk management, leverage and mortgage underwriting. AIG, for example, wrote $3 trillion of credit derivatives with a grand total loss reserves against any payout of zero dollars. Bear Stearns and Lehman Brothers were able to expand dramatically into the mortgage-backed security space using very little capital and lots and lots of leverage. You remember how that worked out.

4 Subprime loans: More than 50 percent of subprime loans were made by nonbank mortgage underwriters not subject to comprehensive federal supervision; another 30 percent were made by thrifts also not subject to routine supervision. With this, traditional lending standards disappeared. Millions of unqualified borrowers poured into the residential housing market as overleveraged buyers.

The irony is that dropping credit standards is a key factor in just about every bubble and financial crisis in history. Call it a lesson never learned.

5 Leverage rules: In 2004, the Securities and Exchange Commission issued the "Bear Stearns exemption," replacing the existing Net Capitalization Rule — that is a 12 to 1 leverage limit — with essentially unlimited leverage for the five largest investment houses. Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns were given carte blanche to pile as much obligation onto their capital base as they saw fit. Following the rule exemption, they leveraged up 25, 35 even 45 to 1.

Less than five years after the exemption was granted, none of these companies existed in the same structure as before the rule change.

6 Mortgage underwriting standards: Beyond the subprime mortgages, lending standards dropped for home purchases in the 2000s. Many lenders stopped verifying income, payment history and credit scores. The 20 percent down standard disappeared. No money down loans rose up. "Piggyback mortgages" piled on a second mortgage. Not to mention "innovations" such as adjustable-rate mortgages. What followed? Rising home prices, housing overstock and booming defaults and foreclosures.

7 Automated underwriting: Loan demand became so great that bankers developed an automated underwriting system that emphasized speed and volume over accuracy and risk management. And the players all learned how to game the system. Real estate agents and mortgage brokers used corrupt appraisers to facilitate loan approval. Mortgage brokers learned how to tweak even the worst loan application to get it approved. Even bank loan officers circulated "unofficial" cheat memos on how to get lousy applications through the automated system.

8 Collateralized debt obligation (CDO): Here is an issue for those of you who believe markets are so efficient: CDO managers created trillions of dollars in mortgage-backed securities without really understanding what was going into these giant mortgage pools. The institutional investors — pensions, insurance firms, banks — who bought these appear to have failed to engage in effective due diligence. This teaches us just about everything we need to know about self-regulation of the financial industry. Indeed, given the outsize bonuses of bankers and the profit motive of banks themselves, financial self-regulation does not appear to be remotely possible.

9a Glass Steagall: The Depression-era Glass Steagall legislation was effective in keeping Wall Street crises separate from Main Street. Think back to the 1987 crash — it had little impact on the broader banking industry. But the repeal of Glass Steagall in 1998 allowed FDIC-backed depository banks and Wall Street investment firms to become intertwined. It took less than 10 years for the entanglements to become extremely dangerous. By the time the 2008 credit crisis hit, the troubles on Wall Street were inseparable from Main Street. So banks and investment firms collapsed together.

9b State banking regulations: Many states had anti-predatory lending laws on their books. These prevented the making of loans or mortgages to borrowers who could not afford them. In 2005, these state laws were "federally preempted" by order of John Dugan, head of the Office of the Comptroller of the Currency. States with anti-predatory lending laws saw lower default and foreclosure levels than states that did not have them. Not surprisingly, after the preemption, default and foreclosure levels in those states rose.

10 Fannie and Freddie: In 2006, more than 84 percent of subprime mortgages were issued by private lending institutions not covered by government regulations, according to data from McClatchy. Indeed, before 2005, the government-backed private firms Fannie Mae and Freddie Mac were not allowed to buy nonconforming loans. But they were losing massive market share to Wall Street and, in response, petitioned their regulator for permission to buy alt A and subprime loans. Fannie and Freddie plunged headlong into the junk bond market just as the housing market peaked. But it was the profit motive and competition — not government policies — that led to this.

Where does this leave us? We have created an intensely concentrated financial industry, where a handful of banks control the majority of assets. Competition is less than it was before the crisis, and bank fees are creeping upwards.

While risk-taking remains rather subdued, history informs us it is likely to return as the crisis fades in the collective memory. The bailouts left us with a legacy of poor balance sheets and moral hazard. None of 10 factors discussed above have been, in any meaningful way, resolved.

The debt ceiling is the least of our worries.

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THE COLOR OF MONEY

For those taken down a few rungs, know that you can climb back up

COLOR FROM G1

for its monumental failure to tame predatory lenders. And it would absolve the lenders who came up with exotic mortgages that should never have been pitched ubiquitously, especially not to financially fragile minority borrowers. But blaming the victim is what we do so well in America.

So let me get this out of the way:

There were people who took on too much home debt. And many should have known better.

Minorities, of course, were simply following the strategy that had been working for their white counterparts for decades. They were using their house to climb up the economic ladder because home equity was, and still is, the single largest contributor to household wealth. The path to middle-class status often starts with owning a home, with families diversifying their assets as their income grows.

Hispanics derived nearly two-thirds (65 percent) of their net worth in 2005 from home equity. It was 59 percent for black households. For whites, home equity accounts for relatively less of their total net worth — 44 percent in 2005.

White homeowners saw the median value of their home equity decline from an average $115,364 in 2005 to $95,000 in 2009. Black homeowners saw their values go from $76,910 in 2005 to $59,000 in 2009.

For Hispanics, the drop was even steeper, tumbling from $99,983 to $49,145 — about half. The Pew study noted that a disproportionate share of Hispanics live in California, Florida, Nevada and Arizona, states experiencing the biggest declines in housing values.

With the collapsed housing market come critics who want to blame the meltdown on federal policies aimed at boosting homeownership among minorities. It wasn't the policies. It was the execution.

CARLA BROYLES/ THE WASHINGTON POST

In 2002, President George W. Bush hosted a conference on minority homeownership at George Washington University. What he said then is still true today.

"Two-thirds of all Americans own their homes, yet we have a problem here in America because fewer than half of the Hispanics and half the African Americans own the home," Bush said. "That's a homeownership gap. It's a gap that we've got to work together to close."

Close that gap, Bush said, and "our communities will be stronger, and so will our economy."

Yet closing the housing and wealth gap is still going to require some good, well-executed policies out of Washington. Bush noted that the top barrier to increasing homeownership was coming up with a down payment.

Under the Obama administration, there's a proposal to require a 20 percent down payment for families to qualify for the best mortgage rates. If they don't meet this threshold, their loans would be considered more risky. Such a requirement would disproportionately affect minorities.

It wasn't the lack of down payments that crippled the housing market. The fact is, lenders can and have made loans for years that perform well without people plunking down hefty sums upfront.

The Pew report is further evidence that we need to continue encouraging families to diversify their financial holdings. But at the same time, as a public policy, we should not abandon efforts to increase minority homeownership for financially stable families.

As that mother in Hughes's poem reminds us, we ought to be encouraging people to keep climbing even though life ain't no crystal stair.

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How to prepare a portfolio for disaster

U.S. debt default could unleash volatility. Diversify to ride it out.

BY KATHY KRISTOF

The inability of legislators and the Obama administration to agree on a plan that would allow the United States to avoid defaulting on its debt underscores an unsettling truth: Every portfolio needs a little disaster proofing. And that does not mean throwing all your money into havens, such as gold, whenever the investment markets turn scary.

After all, the go-to haven for years has been U.S. Treasury securities, the very investment at risk of default if Congress does not enact legislation raising the debt ceiling by early August.

Kiplinger

Default remains a long shot, either in the next couple of weeks or over the next few years. But if the Treasury did default, experts believe, the repercussions would be wide-ranging. Bond values would fall, stock prices would plunge, and even money market funds could be at risk because they're loaded with short-term Treasury and government-agency IOUs.

"There is no safe place to hide in this one," said Hugh Johnson, chief investment officer of Hugh Johnson Advisors, an Albany, N.Y., investment firm with $2 billion under management.

But there's a flip side: When bond values fall, yields rise, increasing their attractiveness for income-hungry investors. When stock prices plunge, dividend yields can become downright mouthwatering. When the dollar gets hit, gold and foreign currencies become comparatively more valuable.

The moral of this story?

Diversify. And keep some powder dry — in other words, have some cash available to handle whatever happens. That should allow you to limit your losses and take advantage of the opportunities that volatile markets create.

"This is a reminder that some of the basic principles of investing are worth following," Johnson said. "You need to diversify among asset classes — stocks, bonds and cash. Diversify among investments in different countries — U.S., Europe, Asia and Latin America. Diversify your stock holdings among different industries. And diversify your bond portfolio between government and corporate bonds."

Thomas Atteberry, manager of the FPA New Income fund, said his only caveat to the message of broad diversification is that long-term bonds are not providing yields high enough to offset the risks the bonds present. In today's environment, he'd keep bond maturities short and hold on to more cash and dividend-paying stocks than usual.

Crushing debt burdens in the United States and throughout much of Europe create an uncertain environment, he said. "It gets difficult to commit capital with any real comfort," he said. "Investors need to sit back and think long term."

What about gold? The metal, which is often considered a hedge against inflation and a falling dollar, is selling at record highs. The last time it rose this far and fast, in the late 1970s and 1980s, it spent the subsequent 20 years falling back to earth, said Kate Warne, market strategist with the Edward Jones brokerage firm.

There's no saying what gold will do now, but it also hasn't proven to be the efficient hedge against bad markets that its backers suggest it is. Warne thinks that because of gold's lofty price, it's a particularly bad time to be buying it now.

Long term, what matters most is that your investments suit your goals, Warne said. That should allow you to stay calm — and invested — even when the markets are not.

"What's worked in the past is to have a diversified portfolio of stocks and bonds and remain invested," she said. "What you do with your own portfolio in the long term is going to matter a lot more than what the politicians do short term."

Kristof is a contributing editor at Kiplinger's Personal Finance.