

Why Financial Reform?

By Harlan Green

It is critical to understand that the recent financial crisis was not a natural disaster. It was a man-made economic assault. People did it. Extreme greed was the driving force. It will happen again unless we change the rules," stated the Chairman of the Senate Permanent Subcommittee on Investigations Carl Levin, Democrat of Michigan.

Congress and the Financial Crisis Inquiry Commission are beginning to understand the dimensions of the financial meltdown of 2008 that almost caused another Great Depression. And crimes have been committed, with only Goldman Sachs being charged with fraud to date for misrepresenting the Collateralized Debt Obligations that it sold to clients.

The just-disclosed SEC fraud case against Goldman is a perfect example of a "man-made economic assault". On one side, Goldman marketed subprime loan-backed securities to their clients, while on the other side structuring a deal with another client—hedge fund Paulson & Co.—without revealing that Paulson was betting against it and helped to structure the deal, which is omission of at least one "material fact" and so illegal under securities' laws.

Why the difficulty in pinning down who was responsible, is the question we asked last week. A major source of the problem is the claim the players weren't responsible for any consequences. Even Alan Greenspan had said the Federal Reserve wasn't able to detect asset bubbles—the major cause of most financial meltdowns—so how could anyone else detect them? And if not detectable, than how could anyone be held responsible for causing them, and the losses when they burst?

But behavioral economists such as Robert Shiller, et. al., show that the irrational exuberance that creates bubbles is detectable, and preventable with the right regulation. It is true that no one can predict the future, which is why investors have to be able to trust in the institutions that peddle financial investments before investing in them.

And that is the 'snake oil' component of financial markets, says 2001 Nobelist George Akerlof in a recent Cambridge University, UK conference. Much of the marketing of investments doesn't reveal all the facts. The playing field isn't really level, in other words, and markets are never 100 percent transparent. There are always those—either buyers or sellers—who know more about their products, and may have hidden agendas.

The rating agencies are another example. They caused much of the problem by not downgrading some of the most toxic securities, when they were paid by clients who needed the ratings—a direct conflict of interest.

India's experience is an example of good regulations. Its Central Reserve Bank did not deregulate derivatives' trading, and required much higher capital requirements for those who did trade in exotic instruments. Therefore no credit bubble was created, and India was not affected by the worldwide credit bust.

By now, the consequences of the financial meltdown are visible to all—the loss of 8

million plus jobs, \$11 trillion in wealth, and a real estate market that will take years to recover in the U.S.. The real estate bubble is just the starkest example. As late as 2007, 2 million new homes per year were being built—much more than were needed even then, driven by easy credit and the irrational exuberance of homebuyers who thought that home prices could only go up. Today the number being constructed is little more than 600,000 units, mostly because the excess supply of the boom years hasn't yet been sold off.

And the inventory of new homes is still above 9 months supply at current sales' rates, when the longer term inventory backlog has averaged 6 months.

Whereas, existing home sales are doing better. What Calculated Risk calls the "distressing gap" between new and existing-home sales still exists, because of the tremendous oversupply of homes still on the market—more than 8 months supply at current sales' rates.

In fact, bubbles can be predicted. No less than Robert Shiller in his 2000 book, "Irrational Exuberance", predicted the implosion of the dot-com bubble. In the 2005 second edition, he also predicted the bursting of the housing bubble. And it didn't take sophisticated math.

In the case of stocks, the price-to-earnings ratio had soared to 44 to 1, almost double the 26 to 1 ratio that existed on 1929's Black Friday. In the case of housing, Shiller saw that housing prices had far outdistanced some fundamental indicators—rising in double digits in mid-2000 when construction costs and population growth rose less than 2 percent per year.

And, in a paper he presented to a Federal Reserve Board economic symposium in August 2007, Shiller warned, "The examples we have of past cycles indicate that major declines in real home prices—even 50 percent declines in some places—are entirely possible going forward from today or from the not-too-distant future."

There were numerous others who read the signs, including Bill Gross, Managing Director of PIMCO, the world's largest bond fund. He criticized the credit ratings of the mortgage-based Collateralized Debt Obligations (one type of insurance derivative) now facing collapse:

"AAA? You were wooed," he said, "Mr. Moody's and Mr. Poor's, by the makeup, those six-inch hooker heels, and a 'tramp stamp (tattoo)." Many of these good-looking girls are not high-class assets worth 100 cents on the dollar... [T]he point is that there are hundreds of billions of dollars of this toxic waste... This problem [ultimately] resides in America's heartland, with millions and millions of overpriced homes", as quoted in Nouriel Rubini's Global Economics blog.

Many experts predicted both the housing and derivatives collapse, in other words, which was the result of the unregulated derivatives market that operated worldwide. And because unregulated, many of the derivatives had little or no capital backup, which created a domino effect. The collapse of one, caused the collapse of others in a chain reaction.

So the main feature of regulation put



forward by both House and Senate bills is greater transparency and more capital to back the transactions. In particular, derivatives, which are bets on the future value of an asset—or even 'CDO insurance' (which is really another derivative in this case) that guarantees the derivative, will be reported through a public clearing house just as futures are traded today. And those offering derivatives must have at least 5 percent of their own money in the transaction.

This will not eliminate the greed that is a basic ingredient of human nature, but

should discourage excessive greed by making it much more expensive. Taking responsibility means being aware of the consequences to others in the larger economy, not just to oneself.



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