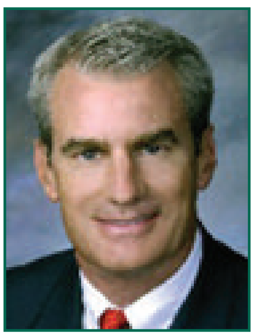
The Credit Crisis:

The Federal Reserve's Role and the Ultimate Impact on Commercial Real Estate



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By Stan Mullin, SIOR, CCIM, CRE, FRICS

"Today was a bloodbath. This was panic-selling." September 16, 2008. Alex Tang, head of research at Core Pacific-Yamaichi, on trading volume in Hong Kong, at its highest in months; Asian stock markets have plummeted following the collapse of Lehman Bros. and the takeover of Merrill Lynch.

In the words of Martin H. Barnes, Managing Editor, *U.S. Bond Strategy of BCA Research "The U.S. economy may not have plunged off a cliff, but it is slipping down a slope and the bottom is not yet in sight."* The mood at this year's Federal Reserve Jackson Hole Symposium was pretty somber. The cycle of deleveraging was and still is in its early stage (as prior lending commitments expire, banks will shrink their assets over the next several years). Risk aversion remains extreme within the financial markets, economic weakness exists throughout the world, most credit spreads were and still are at crisis levels, and the *BCA Research Financial Stress Index* surpassed the levels reached at the height of the 1990 banking and savings and loan crisis.[1]

Worst Economic Crisis—Ever?

Former Fed Chairman Alan Greenspan said that this is "by far" the worst economic crisis he has ever seen. "There's no question that this is in the process of outstripping anything I've seen, and it still is not resolved and it still has a way to go," He went on to say "let's recognize that this is a once-in-a-half-century, probably once-in-a-century type of event."[2]

This article explains:

- why the current crisis in the credit markets was reasonable to expect (we allowed excessive leverage and bad debt);
- that it could have been prevented;

- the role of the Federal Reserve ("the Fed") in allowing this to happen;
- that the list of responsible parties is long and it will be difficult to punish those who played the largest role in causing this meltdown while profiting the most from it (life's not fair); and
- the difficult task the U.S. Treasury has in returning stability to the financial markets, which ultimately will help the commercial real estate industry.

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Let's first look at the Fed's charter:
The Federal Reserve Board ("the Board") sets reserve requirements and shares the responsibility with the Reserve Banks for discount rate policy. These two functions, plus open market operations, constitute the monetary policy tools of the Federal Reserve System.

The Board also has regulatory and supervisory responsibilities over banks that are members of the System, bank holding companies, international banking facilities in the United States, Edge Act and agreement corporations, foreign activities of member banks, and the U.S. activities of foreign-owned banks. The Board also sets margin requirements, which limit the use of credit for purchasing or carrying securities.

In addition, the Board plays a key role in assuring the smooth functioning and continued development of the nation's vast payments system [see Fedwire and Payment System Risk Policy]. Another area of Board responsibility is the development and administration of regulations that implement major federal laws governing consumer credit such as the Truth in Lending Act, *the* Equal Credit Opportunity Act, *the* Home Mortgage Disclosure Act *and the* Truth in Savings Act [see Consumer Information and Community Development].[3]

How We Got Here

During the last six years of Alan Greenspan's almost three decades at the helm of the Fed (August 1987-January 2006), do you think that: bank reserve requirements, the discount rate, and margin requirements were high enough? Were banks sufficiently regulated and supervised to ensure compliance with those regulations?

In my opinion, the answer is no on all accounts. Did Fed monetary policy keep the economy growing, while simultaneously holding down inflation?[4] Yes, but it was primarily during the last years of Greenspan's tenure that he—as arguably the most powerful financial figure in the world—had the opportunity to develop, set, and enforce policy that would have contained the *"irrational exuberance"* in the financial markets that he frequently mentioned. Most economists knew back in 1999 (after the fifth straight year that U.S. stocks yielded returns in excess of 20 percent) that these returns were unsustainable (the dot.com bubble burst in March 2000, resulting in negative GDP growth in the first quarter of 2001). Warren Buffett sets a 15 percent annualized compounded return as his yield target.

Greenspan has an incredible mind and is, by all accounts, an exceptionally engaging man, but much has been written about his early years as a disciple of Ayn Rand, a Russian-born writer who a half century ago, warned about the creeping socialism she saw in America. In *Atlas Shrugged*, Rand told the story of John Galt, a shadowy figure who was fed up with high taxes, burdensome regulations, and interference from government.

Lack of Regulation

Greenspan also was not a fan of regulating the financial markets and his policies at the Fed reflected that view. In 2004, Greenspan suggested that more homeowners should consider taking out adjustable rate mortgages—at a time when the Fed's own funds rate was at an all-time low of one percent, making it the worst time for homeowners to take his advice. For decades the U.S. has scoffed at the European economies because of their greater willingness to regulate commerce. Even as recently as 2007, German chancellor Angela Merkel criticized the United States and Britain for opposing German attempts to put greater regulation, or at least reviews, of the financial sector on the international agenda when she was leading the G 7. [5]

Today, even though the U.S. has had a generation of unmatched prosperity, the U.S. is paying the price for its unwillingness to regulate commerce effectively. In short, the Fed (and the SEC) did not do their job and the Treasury is left to deal with the consequences.

Credit is the air that financial markets breathe . . .

Consumer Overextend-Money Lenders Reap Profits

What happened? U.S. consumers took on far more debt than they should have, mortgage brokers and banks made a ton of money originating fees by lending debt they knew in many cases would default, banks made additional fees selling off these loans to investment banks (IBs), IBs securitized and leveraged those huge pools of debt to staggering levels, the rating agencies over-valued those securities (earning hefty fees in the process), and finally the banks earned fees selling much of that toxic waste.

Would the U.S. be in this financial crisis if all that occurred was the lending to non-qualified borrowers? No. We would have had problems, but they would be nominal relative to today's economic abyss. Is the issue simply that housing prices have fallen (because of overbuilding, loan defaults, and foreclosures) and the property market hasn't reached bottom? No, although housing prices will have to stabilize to settle the markets. Then what brought us here? According to Henry Paulson "…that root cause is the housing correction which has resulted in illiquid mortgage-related assets that are choking off the flow of credit…." [6] I believe that he is only telling part of the story.

Dervatives Markets

The rest of the story involves leverage, beginning in the 1980s and 1990s in the form of structured finance, expansion of the derivatives markets, and the mathematization of trading.[7] For example, AIG is mostly a safe, well-run insurer. But its financial products division, which accounted for only a fraction of its revenues, wrote enough derivatives contracts to destroy the firm and shake the world. Its contracts—almost $450 billion worth in the credit-default swaps market alone—underpin the health of the world's banks and investment funds. The collapse of its insurance arm would hit ordinary policyholders.[8] Among its many products, AIG offered insurance on derivatives built on other derivatives built on mortgages. It priced those according to computer models that no one person could have generated, not even the quantitative magicians who programmed them. And when default rates and home prices moved in ways that no model had predicted, the whole pricing structure was thrown out of whack.[9]

Hedge Funds

Credit-related hedge funds typically leverage their equity five to 10 times. Assume a ratio of five to one. For every dollar of its own capital it invests, five more are borrowed. Now assume it wants to buy the lowest (the "equity") tranche of a big Collateralized Debt Obligation (CDO). A normal CDO's equity tranche with fairly risky underlying assets (think loans) might absorb five percent of the portfolio's first losses. A hedge fund that buys that position would be leveraged 20:1, because the loss of just 1/20 (five percent) of the portfolio wipes out the entire position. It wasn't uncommon for hedge funds to be leveraged five times this amount (100:1). In that event, if there is a one percent loss in asset value, all equity is wiped out. If the loss in value is more than one percent, the equity investors (or ultimately the U.S. taxpayer) have capital calls far exceeding their initial investment.[10]

Assets and Credit

We have to remember that there is a difference between asset and credit bubbles. Credit is the air that financial markets breathe, and when the air is poisoned, there is no place to hide.

Not long ago, the sum of all financial assets—stocks, bonds, loans, mortgages and others—which are claims on real things, were about equal to the global GDP. Now they are roughly four times the global GDP. Financial derivatives, a form of claim on those financial assets, now have theoretical values of more than 10 times the global GDP. The soaring ratio of credit to real output is a measure of leverage, or financial risk. Think of an inverted pyramid. The more claims that are placed on top of real output, the more wobbly the pyramid becomes, and when it tumbles, it tumbles fast. In many circles, the likely amount of total write-downs that will occur in an orderly deleveraging is $1 trillion (and large-scale market reversals are seldom "orderly."[11]

When consumers don't have money to spend and banks don't have money to lend, the rate of interest becomes irrelevant.

In short, the financial markets need two things: 1.) capital—when financial institutions book losses, they need money, and 2.) to get smaller—the financial services industry's share of corporate profits rose from 10 percent in the early 1980s to 40 percent at its peak in 2007. The credit boom not only inflated asset prices (including commercial real estate), but it also inflated finance itself. By one calculation, profits in the past decade amounted to $1.2 trillion more than you would have expected (guess what de-leveraging will do to those profits?). The finance industry will not be able to make money after the boom unless it is far smaller; and as finance shrinks, credit will be sucked out of the economy—and without credit, people cannot buy houses or commercial property, run businesses, or invest in the future.

The Bailout

In September 2008, Fed Chairman Ben Bernanke urged swift action on a Treasury Department plan to buy illiquid mortgage-linked securities saying, "Despite the efforts of the Federal Reserve, the Treasury, and other agencies, global financial markets remain under extraordinary stress. Action by the Congress is urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy…"[12]

What does the $700 billion Troubled Asset Relief Program (TARP) do? It allows the Fed to overpay for those toxic assets (the outlook for the housing market is so uncertain that investors have been unwilling to buy these exotic securities at any price). Better, in the view of many, for an investor to pick over their carcasses than to take on their toxic assets (i.e. Barclay's initial walk-away from Lehman).

The $700 billion is the maximum amount of mortgage-related assets the U.S. can hold at any one time (the total cost could rise substantially higher). Is there an alternative? Not really. Looking back, the Resolution Trust Corporation bail-out of the savings and loan industry was expected to cost $500 billion, but only ended up costing the U.S. government (taxpayers) $125 billion. That could be the case here if the Treasury is able to buy these assets at a lower price than they eventually sell them. William Gross, CIO, of bond behemoth PIMCO, thinks that the Treasury could earn a positive carry or yield spread of at least seven to eight percent. He has also offered to have his firm analyze the value of the securitized debt in question, so long as his primary competitors do the same.[13] It all depends on the methodology in determining either the Net Present Value of the cash flows or market value (in the latter event, they would likely use reverse-bid auction where the Treasury would put out a list of specific securities it is willing to buy and would hold auctions for a pre-announced quantity of each security or class of security. Holders of securities who wanted to sell them would compete with one another to offer them to Treasury at attractive—that is, lower—prices.). It is a big gambit but one that it seems the U.S. must take.

There is a dilemma that policy makers face here. The higher the government eventually pays for the troubled assets held by banks, the more the rescue will bolster those banks and sustain the lending that is vital to the broader economy. But higher prices would also mean a worse deal for taxpayers. If the government sets prices below the prices that banks have placed on their own holdings, the banks could be forced to take the difference as a loss. Prices could be set by banks most desperate to sell, artificially depressing the value of similar assets on the books of healthy banks. As a result, some healthy banks may become weaker, requiring them to raise more capital than would otherwise be necessary.[14] Herein lies the "mark-to-market" argument that Schwartzman, from Blackstone Private Equity, and others have been decrying for months.

There are thousands of types of mortgage-related securities (i.e., some offer a payout if home prices drop 10 percent, but are worthless if they drop another 15 percent) and the government will have to specify which securities it will accept and it will have broad authority to decide which banks are saved.

Paying for the Bailout

Where will money for this bill come from? (Keep in mind that there is another $400 billion that is envisioned to endow the FDIC to insure money-market accounts, which saw redemptions of five percent out of its $3.4 trillion market between September 15-17, 2008. In the 37-year history of money market accounts, only once (before the two failures on September 16, 2008) was there a fund that lost money.[15]) The Treasury will issue new debt to finance the purchases. To accommodate the new debt, TARP would increase the statutory limit on the public debt to $11.3 trillion. When the Bush Administration took office in 2001, the public debt was half that amount, at $5.7 trillion.

There is ongoing discussion among congressional staff, and the Congressional Budget Office and the Office of Management Budget, about how to "score" the Treasury purchases. The draft legislation states that the "cost of mortgage-related assets...shall be determined as provided under the Federal Credit Reform Act...." However, this would be an odd formulation, since the Credit Reform Act applies to direct loans and loan guarantees originated by the government—not the purchase of market assets.

Adding to the Public Debt

Regardless of how the scoring issues are resolved, the bottom line is that this borrowing would add substantially to the public debt, and U.S. indebtedness to foreign lenders. Of particular importance, the ballooning debt would add substantially to annual interest payments by the Federal government. Net interest payments, already nearly $250 billion per year, consume more than one in five income tax dollars. The new Treasury borrowing would take an increasing bite out of income tax revenues—and leave future generations with the tab for this generation's market meltdown.[16]

Why Lowering Interest Rates Won't Help

Will a reduction in interest rates help bring the U.S. out of its recession? It is unlikely. It didn't work in Japan in the 1990s. When consumers don't have money to spend and banks don't have money to lend, the rate of interest becomes irrelevant. The biggest problem the Fed has to deal with, in this market, is risk aversion on the part of lenders and investors. Today, our financial markets are gripped in fear that there is not enough liquidity in the system. For that reason, "perhaps it is no surprise that traders in the credit-default swaps market (credit default swaps are a type of insurance against bond defaults and the best gauge of risk in the debt markets, are the most widely traded credit derivative product. The Bank for International Settlements reported the theoretical amount on outstanding Over the Counter credit default swaps was $62.2 trillion by the end of 2007) and has recently made bets on the unthinkable: that America may default on its debt."[17] The following statement echoes that concern "…investors considered traditional hedges like precious metals to be more reliable than debt issued by the U.S. government, which could face spiraling debt from the bailout plan."[18]

A Bleak Prognosis

Jeffrey Gundlach, Chief Investment Officer at the Los Angeles-based mutual fund TCW Group, Inc., told clients that the crisis in credit and housing may not abate for several years and is getting worse (as long as until 2014 to reach bottom and sluggish until 2022). He sees the S&P's 500 Index falling 30 percent from its levels in September 2008, default rates on prime loans likely to soar, and problems in European banking as "just beginning." [19]

The Hit to Commercial Real Estate

What is the likely effect on commercial real estate?

- Lower loan-to-value ratios,
- Higher credit standards,
- Lenders will likely inventory more of the debt they originate,[20]
- Recourse for borrowers,
- Lower sale and lease values, and
- Higher rates of interest.

The argument for lower investment and leasing velocity is the limited supply of debt. Conversely, the argument for higher transaction velocity is the forced sale of real estate by owners in need of capital and a large amount of real estate owned assets pushed back into the sale market.

As with any crisis, the key for our industry is to identify opportunities in the market. Warren Buffett and others have done it for years and we can, as well. "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful," he said. A case in point: the Berkshire Hathaway purchase of $5 billion of Goldman Sachs perpetual preferred stock in September 2008.

Recommended reading:

- ***Secrets of the Temple*** by William Greider;
- ***Bubble Man, Alan Greenspan and the Missing 7 Trillion Dollars*** by Peter Hartcher;
- ***The Credit Crisis of 2008 and What it Means*** by George Soros;
- ***The New Financial Order*** by Robert Shiller.

To get a quick understanding of the broader scale of the economic challenges the U.S. faces, see "I.O.U.S.A." the movie.

Endnotes

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