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Wall Street *et al*

By Art Ernst

There is, if you will, a connect between what's behind the current financial crisis and how businesses generally show little desire to serve the public when, for example, they rely on automated phone answering systems for dealing with customer inquiries and complaints.

So, just what does poor customer service have to do with the current financial crisis? Well, on both ends of debt — its creation and its sale — disregard for the needs of customers is at the core.

The BUCK $TAYS HERE

Art Ernst

In short, attitude.

Character.

As of this writing, the Bear Sterns failure is months old, Lehman Brothers just filed for bankruptcy, Merrill Lynch accepted a forced sale to Bank of America, and AIG is in the midst of an $85 billion bailout. In sheer magnitude, though, all this pales in comparison to the government's rescue of Fannie Mae and Freddie Mac through which taxpayers will now guarantee more than $5 trillion in mortgage debt.

On the surface, the cause is simply excess leverage at a time that asset valuations have gone down. If one invests $100,000 in a security that declines 10 percent, one will lose $10,000 and be left with $90,000. If one took that same $100,000, borrowed another $900,000, and then invested the full $1 million in that same security, the 10 percent decline would lead to a loss of the entire $100,000.

The firms that failed did not see their assets drop to worthlessness; although their assets are still worth quite a bit, their debt is worth even more.

Financial companies are by nature leveraged enterprises. With favorable access to funds at lower costs than you or I or even what most companies must pay, it is naturally profitable to borrow cheaply and lend expensively. Regulations limit how much leverage, or borrowing, institutions can utilize, mainly because there are occasions when investments turn south.

Historically, failures, especially huge ones, have been rare. Procedures like research, analysis and due diligence helped ensure the creditworthiness of borrowers as well as the probable prospects of stock issuers. Meanwhile concepts like "know your client," risk assessment, and proper portfolio management provided impetus for issuance of quality securities for the ultimate buyer.

There have certainly been previous episodes during which markets devastated financial firms. Leverage is nothing new, and losses in the past were absorbed by accumulated prior gains and/or justifiable new capital. So, just what is different this time?

While there are undoubtedly many sidebars and technical factors, the massive scale of the current problem is indicative of a more fundamental cause. In news reports, we learn that many troubled firms do not know the extent of their possible losses because they are not clear on what it is they actually own. Stated otherwise, financial institutions that create and manage securities for the rest of us are in trouble because they do not comprehend the nature of those very securities. Imagine a car company sitting on a huge inventory of vehicles that won't sell because the manufacturer itself is not sure if they will work. Worse yet, imagine the company still goes ahead and sells the cars to an unknowing public.

How could any prudent investors put so much money into things they do not understand? To be fair, traders and money managers are certainly cognizant of interest rates, maturity dates, and all the details pertinent to rates of return and such. It is highly probable that financial firms borrowed money and built portfolios which in normal times would have kept delivering excellent profits.

Over time, mortgages have always had the underlying asset of a home and a motivated homeowner to provide a sense of safety to the lender. Aggregate hundreds and thousands of mortgages into a diversified pool, there is much reason for confidence.

Since mortgage securitization has been around for some time, safely providing good returns to fixed income investors while fostering efficient funding to borrowers, something must be different.

And there is.

At the core, there are two major shifts that created the current mess: a government-led drive to lend money to poor credits, and a market-led drive for short-term profits.

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Poor credits

Without ascribing blame to any party or administration, it should be known that the government unconsciously caused a massive deterioration in overall market creditworthiness by encouraging lenders to provide funds to unviable borrowers. From the mid-1990s onward, federal agencies wanted to increase home ownership among the poor, particularly among minorities. The problem here is that banks and other institutions already apply time-tested methods to determine if a loan is likely to be repaid. The government anointed itself credit analyst supreme and basically ordered the financial industry to violate sound precepts.

Luckily for lenders, there exists mortgage securitization. Banks could make lousy loans, pool them together, and sell them to agencies such as Fannie Mae and Freddie Mac or directly to an investment bank. Investment banks could then repackage mortgage flows into a variety of esoteric products and push them on to unsuspecting mutual funds, pensions, insurers, you and me.

In this whole cycle, we see the abuse of "other peoples' money." The government using the bank's money to encourage home-ownership, the bank using agency money to dump the bad loan, the agency using financial institution money to build its inventories, and financial institutions using investor money to buy the various fixed-income products. That last buyer, whether another investment bank or a mutual fund shareholder, has no idea how poor of a credit the initial mortgagor is. Thanks to government interference, there is more bad outstanding credit than ever.

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Short-term profits

Until a little more than a decade ago, a prospective borrower had to go to the bank and ask for the privilege of a loan. The bank, balancing long-term profit with customer service, would evaluate likelihood of repayment not just for its bottom line but also to guide its client so that money was left over for a good lifestyle.

Compare that to what ensued.

If you owned a house and a phone between 1995 and a year ago, you were probably called during dozens of dinnertimes by a slew of mortgage brokers. Such brokers earn commissions by getting loans closed, whether or not the loan is well structured or even a good idea in the first place. The broker makes money. The lender gets points and other fees and even makes money selling the mortgage. The ultimate holder of the mortgage may or may not have wanted to invest in a security backed by the person who borrowed the money. If the loan fails, the borrower stands to lose the home and the investor loses his or her money.

Clearly, the focus on short-term profit led to needlessly stretched budgets and massive investment losses.

Customer service

Well, what do borrowers want (and deserve)?

They want to own a home and live a good life. There are rational levels of debt that allow for such. No one wants to lose a home in foreclosure or live hand-to-mouth with income that barely meets bills. A loan officer with integrity will help people obtain a proper level of debt. By doing so he helps the borrower and the ultimate investor. A mortgage officer, whether an independent broker or a staffer at a major institution, pushing teaser rates and other schemes that lead prospects to borrow more than they should is disserving the client.

What do investors want (and deserve)?

They want reasonable expected returns at an appropriate level of risk. It is the duty of investment advisors to match clients with appropriate securities. An investment officer — whether an independent advisor, a big firm broker or an institutional portfolio manager who buys securities with unclear risks — is disserving the client.

Basically, if the customer was facing people in the financial industry who had simply done their jobs and served their clients properly, the vast majority of unworthy loans would not have been made and, in turn. none of them would have been bought.

What now?

As with every preceding crisis, we will come out of this a little wiser. We will also come out quite leaner. Lending standards have already become more stringent at almost every bank. Loan ratios of 100 percent of home value are rare, appraisals are now factoring in recent market declines, and institutions have been quite choosy among applicants since access to funds has recently been restricted.

There will be more failures and more mergers. Since taxpayers are funding the big bailouts, you can bet there now will be more government scrutiny and regulation. Some of it will be good. Some will not.

On the bright side, mortgage defaults do not result in complete loss of value. Homes are worth something, and homeowners can always pay something. If the national foreclosure rate skyrockets from its current three-decade high of 6.4 percent to 10 percent, and forced sales only generate 70 percent of the foreclosed property mortgage balances, then total losses on the roughly $10 trillion in mortgage debt would amount to about $300 billion. For reference, the S&L bailout which involved the federal takeover of about 300 thrifts with $519 billion in assets ended up costing taxpayers about $124 billion. GDP at that time was around $6 trillion versus today's $14 trillion.

So, there will be dislocations and much pain, but both will be readily absorbed.

In the meantime, we can only hope that people do their jobs and provide services that we expect and pay for.

We will forever be navigating phone menus and websites but hopefully lessons have been learned. When dealing with people, we are wise to evaluate character as well as the products presented.

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