The Credit Crisis and the Emergency Economic Stabilization Act of 2008

Barry Habib
Chairman of the Board, Mortgage Success Source

On Friday October 3, 2008, President Bush signed the $700 Billion Emergency Economic Stabilization Act of 2008 into law. The legislation authorizes the government to buy securities of all types from banks and financial institutions, in an effort to help "delever" these companies who have seen their leverage ratio (the ratio of outstanding loans to capital) move above acceptable levels. This bill will also allow troubled banks to recapitalize and begin lending again to businesses large and small, as well as to consumers and even students needing loans for college.

HOW THE CREDIT CRISIS REACHED ITS RECENT CLIMAX

Essentially, the credit crisis began with investment banks selling securitized packages of mortgages and investments known as collateralized debt obligations, or CDO's, that were filled with subprime mortgages to institutional investors and hedge funds. Large insurance companies like AIG also sold credit default swaps against these mortgage backed securities and lost Billions of dollars doing so. You can think of credit default swaps as a type of "insurance policy" for these mortgage backed securities, where companies like AIG collected a risk premium from investors in exchange for guaranteeing the securities against default. These investments lost money as mortgages defaulted, creating a crisis that spread to become a wider ongoing financial catastrophe, characterized by contracted liquidity in global credit markets and banking systems. A downturn in the US housing market, coupled with unsound lending and borrowing practices, as well as excessive individual and corporate debt levels created a meltdown in the global credit markets.

To make matters worse, banks were forced by accounting rules to value their illiquid, subprime contaminated mortgage backed securities and credit default swaps with a "mark-to-market" methodology. This means these assets had to be assigned a value based on the current market price for certain types of mortgage backed securities, which no one wanted to invest in or buy. Since no one wanted to buy them, the value of these assets had to be marked lower and lower...which resulted in an unacceptable ratio between capital and outstanding loans...being the leverage ratio mentioned previously.

To bring the ratio back in line, the only options are to raise capital - which is difficult for a troubled financial institution to do - or to reduce the amount of outstanding loans by selling them at firesale prices. But selling these loans off only exacerbates the problem, as the institution selling them off posts greater losses...which then continues the vicious cycle for that lender. Thus, you can see how quickly some lenders have gotten into deep trouble or even gone under. Worse yet, the firesale prices made in desperation on the selling off of these assets creates problems for other institutions, who now need to mark or value their own assets to reflect the new lower comparable prices in the marketplace that were a result of the firesale.

THE HISTORY OF "MARK-TO-MARKET" ACCOUNTING

Mark-to-market accounting was first developed in the 1800's on futures exchanges, but began spreading to big banks and corporations in the 1980's. During the 1990's, unscrupulous corporate executives of companies like Enron discovered ways to modify mark to market procedures, in order to perpetrate accounting fraud with derivative investments that were very difficult to objectively value. Derivative assets were instead "marked to model," that is, marked or valued according to mathematical models that could be tweaked to yield the desired results.

Following the Enron scandal, the Financial Accounting Standards Board tried to correct such accounting irregularities by issuing Statement No. 157, the "Fair Value Measurements." This new statement to objectively value assets became known as FASB 157 and became effective after November 15, 2007.

While this new accounting procedure seemed perfectly acceptable at the time, as described above, FASB 157 and "mark-to-market" accounting played a critical role in helping to create and dramatically worsen the current credit crisis.

Additionally, banks also couldn't trust each other's collateral for inter-bank loans. They couldn't take the risk of loaning money to other banks that could go bankrupt overnight. This led to a freeze in the credit markets, the commercial paper market, and money markets overall.

Further, with banks unable or unwilling to lend to each other until the credit crisis was resolved, many businesses were beginning to be faced with the prospect of being unable to borrow the money they need to fund their daily operations like buying inventories and paying their weekly employee salaries. This would likely lead to further job losses, and in turn, consumers worried they wouldn't be able to get car loans, student loans, mortgages, or even a credit card.

Bottom line, the credit markets are the lifeblood of the economy, and without them functioning properly, the economy can quickly grind to a screeching halt.

THE EMERGENCY ECONOMIC STABILIZATION ACT

The government realized that the credit crisis represented the greatest threat to the economy since the Great Depression, and that extreme measures like the Emergency Economic Stabilization Act needed to be taken in order to hopefully prevent another Great Depression from taking place.

One potentially beneficial feature of the Act is found in Section 132. This section, titled "Authority to Suspend Mark-to-Market Accounting", reaffirms the Securities and Exchange Commission's authority to suspend FASB 157 if the SEC "determines that it is in the public interest and protects investors." You have to wonder what the SEC is waiting for...but then again, we are talking government bureaucracy here.

Another Section of the Act to note is Section 133, titled "Study on Mark-to-Market Accounting", which requires the SEC to conduct a study on mark-to-market accounting standards as stated in FASB 157. The SEC is supposed to consult with the Federal Reserve and the Treasury Department on the impact FASB 157 has played on corporate balance sheets and to report their findings to Congress within 90 days following the study's conclusions. The end of the 90 day time period is January 2, 2009.

However, on September 30, the SEC issued a clarification on "fair value" accounting as it pertained to financial institutions owning mortgage backed securities. This explanation states that forced liquidations - or firesale type transactions - are not indicative of "fair value", as such liquidations are not "orderly" transactions. It also states that expected cash flows generated from mortgage backed securities are an "appropriate means of valuation, subject to applicable adjustments for default risks."

Prior to this SEC clarification, FASB 157 accounting forced many companies to greatly lower the value of their mortgage backed securities due to a non-liquid market...meaning companies couldn't sell these assets to anyone. This resulted in margin calls from investors, even though the cash flows generated from these investments indicated a far greater underlying value.

THE TROUBLED ASSETS RELIEF PROGRAM

The Emergency Economic Stabilization Act also provides the authority for the US Treasury to establish and manage a Troubled Assets Relief Program (TARP) managed by a newly created Office of Financial Stability. It provides immediate funding of $250 Billion for the Treasury to buy distressed assets, and then requires the President to certify that an additional $100 Billion in funds are needed, with a final $350 billion in funding subject to further Congressional approval. Through the TARP program, the Secretary of the Treasury may use the funds "to buy residential and commercial mortgage loans, credit card securitizations, auto loans and other financial assets for which there is no current market."

Banks or other financial companies that sell their illiquid assets to the Treasury must provide warrants to the Treasury, so taxpayers can benefit from any future growth of the companies. The program's cost will be partially recovered from "a small, broad-based fee on all financial institutions." As a condition to participate in the program, companies will lose certain tax benefits, must limit executive pay and "golden parachutes" for company executives, and return unearned bonuses. An inspector general is also assigned to the TARP program to protect against waste, fraud and abuse.

On Tuesday, October 14, 2008, a plan was announced by the Bush Administration to allow the Treasury to buy equity stakes in nine of the largest US banks and possibly hundreds of smaller banks through the TARP program with its initial $250 Billion dollars in funding. The banks receiving funding in exchange for preferred stock include Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street Corporation, Wells Fargo, Bank of America and Merrill Lynch.

THE BOTTOM LINE: WHAT DOES THE FUTURE HOLD FOR MORTGAGE RATES?

The question now for mortgage borrowers is how could this $700 Billion dollar rescue bill affect mortgage interest rates? The answer to this question has to do with how the Government and US Treasury will fund the TARP program. Many analysts believe the government and the Treasury Department will have to raise funds by auctioning off massive amounts of new Treasury Bonds. This added supply on top of the usual and customary borrowing needs of the Treasury could very likely force Bond prices lower and raise yields or interest rates higher over time.

Over the past decade, foreign investors and central banks have been large participants in the US Bond market, and have been one of the reasons we have enjoyed historically lower mortgage rates. Now, many of these same foreign investors and central banks have credit crises of their own to battle and have good reason to keep their money closer to home, to help solve their own financial problems. Greater forthcoming Bond supply coupled with projected lower foreign buying support in our Bond markets could result in higher mortgage rates in the future. With real estate at bargain prices and still low interest rates, now may well be the time to act if a home purchase is in your future.

MortgageSuccessSource.com 24 South Holmdel Road, Holmdel, NJ 07733 (800) 963-1900