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Experts Grapple With Financial Crisis

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By Robert Feinberg

A panel of veterans of the ongoing, permanent financial crisis assembled at the Cato Institute on Nov. 17 to talk about the book Financial Stability: Fraud, Confidence and The Wealth of Nations, by Christopher Whalen, senior managing director and head of research at Kroll Bond Rating Agency, and Fred Feldkamp, a securities lawyer retired from Foley and Lardner LLP, with comments by Paul Miller, managing director of FBR Capital Markets, and moderated by Mark Calabria, director of regulatory studies at Cato.

In this case perhaps the term "expert" means "people who should know better," because all three panelists seemed to struggle more than they should, given their extensive experience, to come to terms with the way the crisis continues to unfold under the management of administrations of both parties and putative regulators who identify with the interests of the "too big to fail" financial institutions they're supposed to be regulating.

In introducing Whalen, Calabria pointed to the steady stream of books on the financial crisis that continue to appear with regularity and asked why another was needed. Calabria finds that many of the existing pile focus are incomplete, wrong and focus on the question of whom to blame while missing important details. He praised the book for ensuring that market participants who read its spare 200 pages will be able to understand what a collateralized mortgage obligation (CMO) is and have a better understanding of the policy issues raised by the quest for financial stability.

This writer recommends viewing this presentation because the discussion provides many opportunities to explore tangents that could prove to be highly significant. For example Whalen recounted the seminal holding by Justice Louis Brandeis in the 1925 case of Benedict v Ratner that struck down the practice of general pledges of collateral, leading to havoc in the pre-Depression securities market. The issue of what capital should stand behind financial transactions and what constitutes a "complete sale" sufficient to remove liabilities from the balance sheets of financial institutions was prominent in the 2008 crisis episode, which has yet to be fully resolved.

Instead the monetary and fiscal authorities, the Federal Reserve and Treasury, have resorted to "extraordinary measures" to maintain what Whalen calls "the wheel of commerce," rather than enforce laws that are supposed to restrict and punish evident fraud in the mortgage-backed securities business. The authorities, led by Treasury Secretaries Hank Paulson and Tim Geithner and Federal Reserve Chairman Ben Bernanke, bought bad assets from Citigroup and other troubled banks rather than force investors to take writedowns and shut down Citigroup, as FDIC Chairman Sheila Bair recommended to Geithner, who is a protege of former Treasury Secretary

Robert Rubin, a former chairman of Citigroup.

According to Miller, Bank of America has found its exposure to liability stemming from toxic mortgages far exceeds its modest initial estimates.

Whalen decried the decision by the too big to fail banks to withdraw from the mortgage market and called for the authorities to find an elusive "balance" between enforcing anti-fraud laws and keeping the wheel turning. At the same time that he fears a relapse in the housing market, he worries that investors have learned not to fear the enforcers. He estimated the extent of hidden losses in securities portfolios at $40 trillion to $60 trillion, which would be four times the nation's GDP. At the same time, small banks have had to write off preferred stock in Fannie Mae and Freddie Mac that they assumed was backed by the government. For Whalen the task of each generation of authorities is to "pass the bubble on intact" to the next generation.

Miller wryly recalled that in meetings with regulators they asked him how he was able to spot the problems building in the largest mortgage originators such as Washington Mutual. He responded that the culture of the regulators has led them to give too much credence to CEOs.

This writer recommended to the Reagan transition that it stop the music in 1981 rather than incur the risk of untold magnitude that is temporarily masked by QE-n as the Fed considers what assets to buy next.