

JANUARY 2009

Rebuilding the Crumbling Foundation of the U.S. Economy

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The United States is at a pivotal juncture. Our housing market is in freefall, and the economy is weakening precipitously. Our research, in collaboration with Duke University, indicates that inflation-adjusted U.S. house prices could decline an additional 25-30% from the levels at the beginning of the year, even with the benefit of recent declines in mortgage borrowing rates.¹ The government has already announced numerous steps to intervene in credit markets, with a total potential commitment in excess of \$4.5 trillion, and has deployed over \$1.0 trillion of these funds to little avail. The ineffectiveness of the actions to date reflects the ad hoc, reactive, and inconsistent announcements that have actually increased uncertainty in capital markets. The problems that began with the housing market have since infected the entire financial system and can only be conquered with a comprehensive strategy. I have outlined the framework for such a strategy below focusing on:

- The policy goals that guide the proposed strategy.
- Three primary actions required, in my view, to achieve the goals.
- Reasons why actions announced to date are unlikely to succeed without additional measures.

I believe taking these steps, alongside an intelligent fiscal stimulus program focused on making America even more creditworthy in the long-term, can lead us not only out of this downturn, but also to better growth prospects for years to come.

POLICY GOALS GUIDING THE PROPOSED STRATEGY

1. To reduce the risk that house prices overshoot equilibrium on the downside. There is no question that home prices reached peak levels that could not be justified by economic fundamentals in the last several years. The government should not prevent prices from returning to a level that is sensible and sustainable. Having said that, our research indicates that home prices are likely to overshoot equilibrium materially on the downside, inflicting untold economic damage on the U.S. and global economies. Failure to intervene as prices decline would be even more irresponsible than was the failure to address the situation when prices were rising.
2. To ensure that creditworthy borrowers have access to capital. This does not mean to open the spigot to all borrowers. It is very precisely about creditworthy borrowers. The U.S. consumer binged on debt through the last several decades, as consumer debt as a percentage of GDP exploded from 48% in 1980 to 97% at the end of 2008.² Not all of these consumers should have access to debt. Conversely, many of them *should* have access to debt, as should U.S. companies. Right now the financial system is effectively closed and is indiscriminately preventing the vast majority of borrowers from accessing credit, even when they are creditworthy.
3. To reopen private capital markets, and regulate them so they can serve society once again on a sustainable basis. Free markets can and have worked to generate tremendous wealth for the United States. That said, the role of

government is to ensure that markets function to the benefit of society as a whole rather than any single, narrow segment. Put simply, markets are meant to serve the country, not vice-versa, by fulfilling three primary functions: moving capital from savers to productive enterprises; providing liquidity for investors; and facilitating price discovery to assess how well capital is being used (which then informs decisions about the first function, creating a virtuous circle). At this point, none of these objectives is being achieved. Capital is not moving as it should. Liquidity has collapsed with some assets not trading at all. Price discovery has disappeared for a range of assets, particularly those related to real estate. The goal is not to have government replace markets. On the contrary, the goal is to clear the plumbing so the markets can once again regulate the flow of capital and liquidity effectively. Clearly, the markets failed to handle this task adequately when they were largely unsupervised. Hence, the other important step, which will take more time, is to develop and implement a robust regulatory infrastructure so we become less likely to face a similar situation in the future.

THREE PRIMARY ACTIONS REQUIRED TO ACHIEVE THESE GOALS

1. Remove the bad assets from the financial system. Private investors will not commit capital to the financial sector until they can gain confidence that the companies in which they might invest are solvent. This is not simply about banks. The formal banking system certainly is saddled with unbearable amounts of risky assets, but the shadow banking system is in even worse shape. Unfortunately, the formal and shadow banking systems are too intertwined to simply let the latter fail. The key ingredients that are required for this effort to succeed are to:
 - a. Address the entire system. Dealing with one bank at a time will fail, as this approach merely prolongs the period of uncertainty and is nearly impossible to implement in a predictable manner free of political interference. Moreover, focusing on each bank individually can be thought of as clearing the plumbing within the house, but not addressing the fact that the pipes leading into and out of the house and through the entire neighborhood remain clogged. By addressing the entire financial system, the government will send a strong signal to markets that the era of one-off, unpredictable measures has ended, and that we now have a complete playbook to overcome the challenges we face.
 - b. Create a government-sponsored “bad bank” that will buy bad assets from any owner. The bad bank should focus initially on bidding on all (yes, all) delinquent residential real estate loans owned by banks and in securitizations. This massive bid (over \$1 trillion of par value based on current delinquency figures) could be achieved in a plan somewhat similar to that proposed by the Chairman of the FDIC, Sheila Bair, in which government equity capital is leveraged to buy assets. Given that the plan would focus on delinquent loans, the purchase price would be a mere fraction of the \$1 trillion of par value. The goals of the asset purchases are three-fold. The first is to take the uncertainty around existing bad loans out of the securitization and bank lending markets, allowing investors to commit funds to new and existing mortgage investments knowing the toxic assets have been removed. This measure also reduces the need for direct government mortgage funding over time. The second goal is to facilitate a broad-based government modification effort without violating contract law. The importance of the sanctity of contract law is difficult to overstate, as the United States has enjoyed the benefit of low-cost borrowing for many years due to investor confidence in our justice system and the durability of contracts. This proposal, by having the government own the loans it will modify, protects the rule of law and our access to capital as a nation. Moreover, by taking these homes out of the foreclosure pipeline, the government would achieve the third objective by reducing the downside in home prices nationally, as the supply of foreclosed homes offered for sale (by distressed bank sellers) would decrease immediately.
 - c. Purchase the bad assets at market price or, if necessary, seize them through foreclosure of the entity that owns them. During the thrift crisis, the question of market value versus intrinsic value was not an issue, as the assets were taken over by regulators from the failed institutions. In this cycle, due to the scale of the institutions involved, the government has tried to avoid large bank failures for systemic reasons. The government is right to be concerned about systemic risk, as we have learned all too painfully from the aftermath of the Lehman Brothers debacle. Were a major institution to find itself in the condition of Lehman today, the government should force the institution to sell its troubled assets to the bad bank at the market price. [To the extent that would lead to insolvency, see the third key plank of this proposal.]

2. Embark on a massive modification program while mitigating moral hazard among the ultimate borrowers. Having taken roughly \$1 trillion of bad assets out of the system, the government should embark on a systematic loan modification program. There should be no loan forgiveness on the underlying principle. Instead, the program should assess borrower ability to pay monthly payments and then reduce the payments to a level determined by a formula (e.g., 31-38% of disposable personal income). As long as the borrower continues making these payments, the family would remain in their home, and the community would be stabilized.

To the extent a borrower were to sell the home at a later date, the entire amount of the original mortgage would still be owed to the government. To the extent the borrower sells for less than the amount owed, the government should have a claim on future compensation from the borrower. This point is very important, as the United States is somewhat unique in allowing borrowers to walk away from a home without declaring bankruptcy and without having lifelong liability for the amount owed. There is no reason why taxpayers should bear the burden of bad decisions. That being said, we are beyond the point of finger pointing, as our economy as a whole is now at risk. This proposal achieves both goals of ensuring borrower accountability and achieving social stability.

To the extent a borrower defaults on the modified terms of the new loan, the government would foreclose on the home and hold the borrower liable for the difference between the amount borrowed and the proceeds from selling the home out of foreclosure. (These provisions regarding lifelong accountability can clearly be debated. It is important not to forgive loans right away, as no one is well served by teaching an entire generation of borrowers that they can simply walk away from their debts. To the extent a borrower has been duped by malicious lenders, there should be alternatives to offer just remedies to the borrower and taxpayers.)

3. Force participating banks to raise private common equity, and provide a government backstop to the capital raise where appropriate. This plank is particularly important. Cleansing the balance sheets alone will not lead to new lending. Banks that sell bad assets to the bad bank must be forced to raise common equity immediately. The capital must be in the form of common equity, as this is the first-loss position in a bank's capital structure. As long as financial institutions lack adequate tangible common equity, investors will continue to refuse to invest in them and lending will remain stagnant. The amount of common equity the institution is required to raise is the subject for further evaluation, but a sensible starting point is 5% to 10% of the amount of bad assets sold to the government-sponsored bad bank. We will only reinvigorate lending if we de-risk bank balance sheets and grow the capital base of the financial system. This point is vital, as many policy proposals have been built around false choices that imply these objectives are mutually exclusive. On the contrary, neither approach will succeed independently. I believe the two objectives must be implemented in tandem to achieve our goals.

To the extent the bank attempts to raise common equity and fails, the government should either backstop the capital raise at a severely discounted price or seize the bank (this decision will have to incorporate considerations such as systemic risk and the cost to taxpayers of managing an equity stake in the firm on an ongoing basis relative to the institution's long-term viability). The punitive aspect of a severe discount (e.g., 50%) or seizure is meant to ensure that common shareholders are not bailed out of their bad investment decisions. Even if the common equity capital raise succeeds without a government backstop, existing owners of common equity do suffer (as they should) as they are diluted by new shares issued to new investors. I should note that I am trying to ensure that the proposals balance the goals of penalizing investors and management teams that made bad decisions with the goal of reinvigorating lending. It is important to remain focused on this balance, as there is no benefit to the taxpayers from going overboard in punishing existing shareholders—e.g., taking their shares to zero—as such an example may make investors that much less likely to invest in a bank, making us less likely to achieve our objectives.

The other goal here is to force banks to bite the bullet and truly cleanse, rather than window-dress, their balance sheets. To the extent the bank is viable and has eliminated the bad assets, it should be able to raise private equity capital. To the extent the banks that have purified their balance sheets can and do raise capital, it appears their investors will be positioned to benefit from very attractive lending opportunities. Moreover, with the knowledge that the vast majority of delinquent loans have been removed from the balance sheet, investors should derive comfort that the bank can earn significant net income with little need for incremental loan loss provisions.

WHY ACTIONS TO DATE ARE INADEQUATE TO SOLVE THE PROBLEM

The logical next question is why the measures already announced are not adequate to fulfill the goals outlined above. Some of the actions have had a significant impact. That said, having restored liquidity for banks through the Temporary Liquidity Guarantee Program (TLGP) and for some corporations through the Commercial Paper Funding Facility, the initiatives to date have yet to address the housing industry in a comprehensive way. Nor have they forced banks to remove the risky assets that made the TLGP necessary in the first place. Rather, the measures have been one-off in nature and often have a relatively short lifespan, further increasing uncertainty as investors question how much longer they will have government protection.

The one proposal that was directed at housing effectively was the announcement on 25 November 2008, that the U.S. Federal Reserve and Treasury Department would purchase unsecured debt and MBS issued by the GSEs. This move led to a decline in mortgage borrowing rates of over 150 basis points. Given that a 10 basis point change in mortgage borrowing rates translates into a 1% change in mortgage payment, the announcement and ensuing actions have actually reduced the cost of a mortgage by over 15%, even if the home price has not changed.

The announcement was premised on making it less expensive for new homebuyers to step into the market, on providing incremental demand for homes, and on allowing existing homeowners to refinance into lower monthly payments, affording them more flexibility to spend money or rebuild their balance sheets through saving. While there has clearly been a benefit, interest rates on conforming mortgages alone will not solve the larger problem. For one thing, loans for homes that require a mortgage larger than that available through Fannie Mae and Freddie Mac (or other GSEs) still cost over 150 basis points more than those from government-sponsored enterprises. Also, new home buyers are not easily found, in part because home ownership rates increased to levels well beyond equilibrium during the housing boom. If anything, too many people owned homes and are now being worked out of home ownership by the markets. On the refinancing side, The New York Times reported on 23 January 2009 that only 30% of refinancing applications are being approved, as the value of the home underlying such mortgages has declined so much that it no longer qualifies for a loan.

Put simply, the cost of borrowing is only one element of the home price problem. If markets had more confidence in the idea that we might be near a bottom in home prices, however, the willingness to extend credit to borrowers seeking to refinance or buy a new home would increase significantly. If we cannot easily find new homebuyers, it is that much more important to keep homeowners in their existing residences. That is why the modification program is so important.

As it relates to bank capital, the primary method of recapitalizing the banks has been through the Troubled Asset Relief Program (TARP), using preferred stock investments. Unfortunately, the decision to buy preferred equity has achieved little to nothing other than reminding common equity owners that they are first in line to lose their capital as real estate prices remain in freefall. Given this and the fact that common equity holders elect the board of directors and own the company (as opposed to preferred equity holders who should be thought of as lenders to a bank as opposed to owners), there is no reason to expect a bank to be more likely to lend money after being given large amounts of preferred equity on which they pay interest to the government. The preferred equity choice was ill advised, though the idea of injecting capital was the right one.

CONCLUSION

If implemented, this strategy can significantly reduce the downside in house prices versus the decline our research indicates is likely if markets are allowed to overshoot on the downside. By clearing the plumbing of the entire system rather than continuing on the ad hoc, reactive approach of the last couple of years, the government can decrease the uncertainty that has kept investors on the sidelines even while creditworthy borrowers have been unable to create economic value and jobs. Ultimately, this strategy maintains the necessary balance between the role of private markets and government, by rebuilding the foundations for economic growth led by a properly supervised private market operating in the service of society. The cost of these actions might appear high, but the cost of inaction or continuing on the current path is too catastrophic to contemplate.

NOTES:

1 Refer to “The Crumbling Foundation of U.S. House Prices” Investment Research paper published by Lazard Asset Management, in collaboration with Duke University, on 23 January 2009.

2 Source: U.S. Federal Reserve, Bloomberg.

Published on 26 January 2009.

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