Minding the Store: Washington's Financial Oversight
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Along with the election, coverage the failures of Fannie and Freddie and the bailout, the media is replete with stories of people being crushed by the current economic events. In one public radio interview, an 84 year old retiree stated that they should not have to worry about the solvency of their assets at this stage in their life. There have been reports ranging from the family that lost their home to predatory subprime lending to Deutsch Bank Investment Funds holding the subprime mortgages. Deutsch Bank Funds are the largest owner of foreclosed residential properties in Cleveland, Ohio. Adding to these problems has been the emergence over the last year of failing high risk credit default swaps, the liquidity and credit crisis, rising unemployment and falling consumer confidence. And the coming bailout: the Emergency Economic Stabilization Act of 2008.

The underlying events creating the current economic problems are not new to us, were expected, and largely ignored by regulators and elected officials. Warnings of the potential problems that could be created by a housing bubble, predatory lending, credit default swaps, and free flowing subprime mortgage money have existed since the 1990s. For example, at the early stages of subprime lending fiasco, the attorneys general of all 50 states (representing both political parties) sought to develop consumer protection and legislation to curb subprime lending practices. This included mortgage misrepresentation, lenders failing to consider housing consumers' ability to repay mortgages, teaser interest rates that skyrocketed when the rate reset or ballooned, excessive fees and in illegal kickbacks. Consumer protection legislation against predatory lending practices had strong uniform support in legislatures around the country.

In 2003, in response to these concerns, the federal government invoked an 1863 law which preempted all state legislation on predatory lending. The obscure law that accomplished this was the 1863 National Bank Act which included in its power a clause providing the federal government the right to issue formal opinions preempting all state predatory lending legislation. The federal government's power to curb state level of enforcement of predatory lending abuses and subprime mortgage fraud was carried out under the Office of the Comptroller of the Currency (OCC). The OCC action limited states in protecting housing consumers while the federal government failed to develop any meaningful protective measures to curb subprime predatory lending abuses. The federal government's action was fought by all 50 states attorneys general and all 50 of the state banking superintendents. When the New York Attorney General started an investigation of banks thought to be discriminating in mortgage lending, the OCC filed a federal lawsuit to stop the investigation.

It is important to note that nationally the level of subprime lending in 2000 was $150 billion and by 2005 subprime mortgage loan originations increased to over $650 billion annually. Current estimates of outstanding subprime mortgage range between $1.5 and $2 Trillion. In my humble opinion, the federal government's invoking an 1863 law is not dissimilar to a tax protester who claims that the payment of federal income taxes is prohibited under an 1847 statute of one sort or another.

If we expand our analysis of federal regulatory practices to include consideration of the shenanigans and boondoggles of Wall Street's hedge funds and investment bankers we see a similar pattern to that of the subprime mortgage mess. The federal regulatory agencies failed to address the devastating and high-risk practices of hedge funds and investment banks and how both poorly managed risk. A hedge fund, Long Term Capital Management (LTCM), is an egregious example of this practice.

LTCM began in 1993 with $1.3 billion in capital, a staff of expert bond traders and stock brokers to run and market the company, and Nobel Prize winners to develop investment models to orchestrate investment timing. By 1998, LTCM had over $130 billion in assets ($125 billion of which was debt) invested in international government bond funds. Additionally, LTCM credit swap positions were valued to be about $1.2 Trillion---an investment practice similar to AIG. Because of the computer modeling, LTCM believed that the risk was small given the fact that the complex models showed strong correlations between events and the long and short positions of LTCM. All went fine for LTCM and profits soared until the Russian government devalued the ruble and placed a moratorium on its treasury debt. This triggered a massive flight to quality. LTCM's equity fell, its lenders took substantial write-offs for LTCM debt. Sound familiar? Ultimately, to stop a systematic meltdown resulting from a liquidity crisis, the Federal Reserve Bank of New York put together a rescue package where LTCM's investors injected cash and obtained control of 90% of the company.

In response to the LTCM, the federal government released a study in 1999 entitled Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management. The working group that prepared the study included the U.S. Treasury, Federal Reserve, Security and Exchange Commission and the Commodity Futures Trading Commission. A perusal of this extensive study identifies that the problems associated with LTCM are not confined to hedge funds. The 1999 report found that hedge funds are generally less leveraged than some banks and security firms. The report also found that the excessive use of leverage and excessive risk taking can negatively magnify events. The report conclusions included a statement that when excessive leverage and risk were present, "the chance that problems at one financial institution could be transmitted to other institutions, leverage can increase the likelihood of a general breakdown in the functioning of financial markets."

The recent events experienced in our financial markets remind me of a statement Nicholas II made when he was first imprisoned by the Communists during the Russian Revolution: "could something have been done to prevent this?" Clearly, there are several lessons about mixing high risk and high leverage cocktails. There are many challenges to convince decision makers and regulators that markets and market participants will not always act according to predictive models. Financial forecasting has limitations and must be used with judgment. The market value of assets and how asset values can change must be understood.