

9 Key Talking Points on the Bailout

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What really doomed the bailout? An uninformed public? Here's what to say to people to help them understand how critical this piece of legislation is for Wall Street and for Main Street. What key points would you add?

According to the polls, most Americans look upon the bailout as a \$700 billion blank check to Wall Street's fat cats. The arguments generally include some elements of economic unfairness and class warfare: Republicans vs. Democrats, capitalists vs. socialists, or Main Street vs. Wall Street.

Unfortunately, the ideological debate, while important, is hindering progress on a very real crisis: the American economy is slowly grinding to a halt. But it's not the American people's fault that they don't understand. This is a piece of legislation that needs to be sold. The issues are massively complex, the solutions are enormous in scope, and the numbers are just plain staggering.

Clients and prospects need perspective and context on the issues at hand. They also need some emotional distance. Here are nine points that can educate clients on the big picture and help them understand how a bailout can begin to resolve the economy's immediate issues.

1. **Don't confuse the stock market with the credit market.** Yes, the stock market lost 780 points Monday and regained 485 Tuesday. But that doesn't mean the crisis is over. That doesn't mean the credit markets are safe.

The stock market is about *owning* equities. Credit markets are about *owing* debt. People can live large but owe it all to the bank. So can economies.

One way to help clients understand the difference between the credit and equity markets is to offer an analogy. Think of the economy as a human body. The stock market is the body's temperature, while the credit market is the body's circulatory system.

Rising and falling temperatures indicate problems in the body, but they aren't the cause of the problem, and they can usually be managed with two aspirin.

Credit, on the other hand, circulates throughout the system, fueling businesses, industries, and consumers—all the organs that keep the economy alive. Shut off that blood—even choke it back a bit—and vital organs start to shut down. One organ failure leads to another until the whole system enters a death spiral. That's what happened in the depression of 1929.

2. **The credit markets are frozen.** The lifeblood of the capital system—the credit markets—is on the verge of totally seizing up, because banks don't trust each other's solvency. This solvency and trust issue has the potential to throw the economy into a coma.

Symptoms are already beginning to appear:

- Bank of America refused loans to McDonald's franchisees, and United Airlines is "doing everything short of roaming through its cabins looking for loose change," said *BusinessWeek*.
- California State University campuses, the largest four-year higher-education system in the country, warn they won't be able to accommodate rising enrollments due to budget concerns, reports the *Los Angeles Times*.
- A tractor company recently announced it will no longer provide six months' credit on equipment parts, said Rochester, New York's *Democrat and Chronicle*.
- Credit card companies are offering lower lines of credit, reports the *Associated Press*.

- Approximately 65% of domestic banks have tightened lending standards over the last three months, the Federal Reserve Board reported in August. About 80% of banks reported tightening their commercial real estate loans, and 75% (up 60% from the previous survey) tightened their lending standards on residential mortgages.

3. **How much more money do you want to lose?** The government's failure to pass the bailout bill took \$1.1 trillion off the market Monday—not to mention the trillion lost since the start of September.

Those kinds of losses come directly out of investors' accounts—a fact that will be very apparent when statements arrive in the next couple of weeks. More losses will be forthcoming as the credit markets convulse. True, the bailout may also cost investors \$1 trillion dollars, but they won't have to pony up the cash immediately. In fact, there's a very good chance that taxpayers may never feel the hit if assets are sold in a profitable manner. And some of the best money managers in the world are lining up to sell those assets—for free!

4. **Systemic problems require systemic solutions.** Suppose an arm or leg loses circulation. Amputation is often necessary, but if you don't treat the circulatory issue, the patient could die. The rescues of Bear Sterns, Fannie Mae and Freddie Mac, and AIG were amputations. But they didn't treat the underlying issue. The government needs a broad strategic approach to cure the bad mortgages. In effect, we need a treatment that either eradicates the malignant cells (bad mortgages) or transforms them into benign cells (good assets) that could eventually benefit the system.
5. **Government intervention is necessary.** In an ideal world where rational economic units transact business in a transparent and frictionless environment, markets might be able to work out dislocations on their own. But as noted economist John Maynard Keynes observed, markets aren't always self-correcting. Irrational investors can demonstrate extreme forms of "liquidity preference," stampeding into safe investments like three-month Treasury bills. "Once doubt begins, it spreads rapidly," he said.

Keynes advocated deficit spending during economic downturns to maintain employment and mitigate "social misery." Fed chairman Ben Bernanke, an expert on the Depression, has estimated that if the credit lockup continues, three to four million people could lose their jobs in the next six months.

While the bailout plan may not be perfect, it will create a market where the illiquid mortgage-backed securities can be valued and traded. It will set up regulatory oversight on how these toxic assets are valued and disposed of. It will get money and credit moving again.

And this isn't the first time the government has intervened to solve economic problems. During the savings-and-loan crisis of the 1980s, the government established the Resolution Trust Corporation, which made a profit of \$394 million. President Clinton bailed out the Mexican peso, which made the American taxpayer \$500 million. During the Great Depression, Congress established the Home Owners Loan Corporation, whose purpose was to refinance mortgages to prevent disclosure, and it, too, turned a profit.

Nor does the bailout lead the way to increased socialism. This legislation is not the biggest government intervention ever. That honor belongs to Richard Nixon and his imposition of wage and price controls in 1971. Henry Paulson may privatize unprecedented amounts of debt, but Nixon commandeered the entire economy, says noted economist Robert Samuelson.

6. **More toxic debt is coming.** Clients need to be reminded that this is only the beginning of what could be a very prolonged crisis. Moody's Economy.com estimates that banks made 15 million questionable mortgage loans from 2004 to 2007. It estimates that 10 million of those will default.

These toxic assets are heading toward lenders' balance sheets in waves. The data, according to Clayton Holdings, a reporting service, is grim:

- Subprime mortgage delinquencies have increased. The percent of loans made in 2006 that are now 60 days late reached 40.24% in August, up 5.49% from the previous month. The delinquency rate is 30.82% (up 6.05%) for subprime loans made in 2007.
- The delinquency of Alt-A loans—so-called liar loans, because they were made with little documentation—is growing worse. For Alt-A loans made in 2006, the 60-day delinquency rate is 25.26%, up 9.44% from a month earlier. For Alt-A loans made in 2007, the 60-day delinquency rate is 22.65%, up 16.43% from a month earlier.
- Foreclosures are declining somewhat, but not because there are fewer of them. Banks are slowing the process down because of falling housing prices—which means they are carrying a lot of inventory on their books.
- The ratings services are increasing their loss assumptions. Standard & Poor's now estimates 40% losses on Alt-A and negative amortization loans, up from 35% earlier this year.

Many of the Alt-A loans were made to borrowers with good credit scores but who were not required to document their income or assets. Many of the loans were adjustable-rate, interest-only for the first five to seven years, so their defaults aren't even being felt yet.

What's worse is that there are just as many Alt-A loans as subprime loans. Alt-A loans made up 28% of mortgage-backed securities in 2005—the peak of the lending bubble. Subprime made up 29%, and prime—loans to credit-worthy borrowers—made up 24%, according to *Newsday.com*.

The key point here is that we need a clearinghouse or program in place to deal with years of toxic assets. This is not just a 2008 problem, but one that could last well into the next decade.

7. **We don't know what stocks are really worth.** Companies are carrying more than \$62 trillion in credit default derivatives on their books (compared with \$1 trillion in subprime mortgages). These financial "weapons of mass destruction" are so convoluted and toxic that they have toppled such venerable companies as AIG, Bear Sterns, and Lehman Brothers. Warren Buffett has said it took him four years and \$400 million to unwind the positions in one of his insurance companies.

Why are derivatives so important to get off the books? They are clogging up balance sheets, which affects earnings and stock prices. Price-to-earnings ratios are down, but they are still not cheap, says Rob Arnott, chairman of Research Affiliates, in a recent Pensions & Investing webcast. As balance sheets are cleaned up, there will be fewer market shocks, investors will regain their trust in the market, and equities can resume their upward trend.

8. **Employment will stay steady.** A thriving credit market means employment stays strong. Businesses keep selling and consumers keep buying. "Without the bailout, the unemployment rate could hit as high as 12%," said Brad DeLong, a professor of economics at the University of California at Berkeley. "A successful bailout could help keep the unemployment rate stay below 8% for the next year."
9. **America's superpower status is at stake.** It's imperative to show the rest of the world that the U.S. can act swiftly and responsibly in the face of a crisis. We must be sure that international creditors such as China and other nations continue to be confident in the security of the U.S. economy. Foreigners finance the American economy, and if they stopped buying Treasuries, or started selling their reserves, the dollar would fall and interest rates would rise, squeezing the economy further. "If we were an emerging market, the exchange rate would be down 70% and interest rates would be up at 25%—that's what a crisis looks like," says Kenneth Rogoff, an economics professor at Harvard University.

Perception may be even more important to military might than having a great army or the latest technology. Max Boot, a senior fellow at the Council on Foreign Relations, wrote in a recent editorial in the *Los Angeles Times*:

A visiting Israeli Cabinet minister made an interesting point at a conference in Washington over the weekend. The current financial crisis, he said, is undermining the perception of American power when it comes to dealing with problems such as the Iranian nuclear program, Russian adventurism, or the growing threat from Hamas and Hezbollah. Various actors around the world look at the U.S. and see a crippled giant. That reduces incentives to make concessions to Washington.

Is it merely coincidence that North Korea picked now to reactivate their nuclear plants? Or that Russia is selling arms and nuclear technology to Venezuela? Unfortunately, democratic dithering can look very messy to outsiders, and the lack of decisive action can undermine America's standing as a military and economic superpower.

The crisis is just beginning

In many respects, clients have been lulled into a false sense of security with events to date. The FDIC has quietly stepped in and rescued massive banks that were on the verge of insolvency. What clients may not fully realize is that those banks were indeed seized by the government. They failed. Runs had developed on the deposits. Shareholders were wiped out. And Ken Lewis, president of Bank of America, thinks another 4,000 could fail before this crisis is over.

Ad hoc measures will only go so far to stop the damage. Prolonging the debate is akin to doctors and insurers debating the treatment of the patient while he slowly bleeds out. Help your clients see what's at stake, and bring this issue to a resolution.