

Q&A on the current financial crisis

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We have become aware that we are indeed in an economic crisis. What is the origin of this crisis?

Mortgages are at the core of the current crisis. Lenders extended too much credit loaned under bad terms and provided fuel for the speculation in the real estate market. Homebuyers borrowed too much, sometimes under bad terms and speculated that real estate would continue to increase in value quickly. Many of these loans were made to borrowers with low credit ratings and these are what you have heard being called sub-prime mortgages. Now, when the economy slowed down and food and fuel prices increased, that put stress consumers, workers, and homeowners. This economic slowdown caused a downturn in the real estate market, which then triggered problems for homeowners who could no longer sell their property if their mortgage was too onerous. What followed this difficulty for homeowners was increasing defaults on mortgages and more slow pay on that debt.

Why would homebuyers' difficulty in paying their mortgages cause a broader economic crisis?

Because the problem does not end there. Many of those mortgages were packaged and sold to large banks and insurance companies. And, because there was such a large number of those mortgages that were troubled, the holders of those instruments found themselves with less liquidity than they had planned for.

When you say companies had less liquidity, what does that mean?

In other words, Goldman Sachs and AIG had assets in the form of receipts due from mortgages; these companies also had liabilities due to others in the form of short term commercial debt. Under normal circumstances, these companies were able to maintain a balance between these assets and liabilities, however when other banks and large companies became nervous about liquidity (or the free flow of money) in financial markets, they stopped or reduced the purchase of that commercial debt. The end result is a reduced flow of money between financial institutions and companies, this is what you may have heard referred to as decreased liquidity in financial markets.

I understand that this may affect Wall Street, but why do these things matter to us on a personal level?

This decrease in liquidity in financial markets results in tighter credit. Unchecked this will affect us in everyday life because small business owners will have more difficulty in getting loans for operations or capital needs and consumers will also have more difficulty in getting loans for their needs as well. It is easy to see that this situation is leading to nervousness among consumers and business owners that is resulting in lower spending for consumers and less income and spending for businesses.

So, is it in response to this situation that the Congress took action last week by passing the Emergency Economic Stabilization Act?

Yes, the Congress passed the Emergency Economic Stabilization Act in order to allow companies to sell mortgage backed assets to the United States Treasury. The goal of this legislation is to free banks and insurance companies of these troubled mortgaged backed securities through these sales to the Treasury. These banks and companies would then be able to turn **illiquid, or troubled assets**, into cash, thus improving their financial position and allowing them to lend and borrow more freely. This would result in an increased flow of capital in financial markets. Carrying this further, that increased liquidity would flow to small businesses and individuals who need credit available for business investment and consumer purchases.

Practically speaking, what is in the Emergency Economic Stabilization Act?

I will limit my response to the 113 pages that are actually a part of the Emergency Economic Stabilization portion of the act and not the other 340 pages. The basic provision of the act allows the Secretary of the Treasury to negotiate for the purchase, management, and subsequent sale of trouble assets from financial institutions. The Secretary may also provide guarantees for the payment of certain mortgage backed assets. Participating financial institutions will be required to pay a fee for this guaranty.

What is the cost of this Act?

We don't know, but it is not \$700 Billion. That number is the amount that the Congress has permitted the Treasury Secretary to use to purchase assets from financial institutions. That money will not be "spent" as we normally think of spending. It is an investment in mortgage assets and the ultimate cost of this plan will depend on how much the US Treasury gets paid back from these purchased mortgage assets.

Are there protections in the act for the benefit of mortgage borrowers?

Yes, there are specific foreclosure mitigation efforts outlined in the act most specifically including a provision allowing for the modification of mortgage terms of troubled debts. Mortgage terms that may be modified include term extensions, rate reductions, and reductions in principal.

What sort of oversight will there be over the Secretary of the Treasury in the administration of this program?

The Secretary will be monitored by four groups on a regular basis: the Comptroller General, the Office of the Inspector General, the Congress, and a new Financial Stability Oversight Board (comprised of Chairman of the Fed, Secretary of the Treasury, Director of the Federal Housing Finance Agency, Chairman of the SEC, Secretary of Housing and Urban Development);

Are there any provisions in the act that are not specifically addressed at the mortgage crisis?

Yes there is a requirement for the study of the practice of trading securities on margin and a requirement that the Chairman of the SEC consider changing accounting rules for marking securities up or down to market prices. There is also a provision to increase the allowable US Government debt level to \$11.3 Trillion. There will also be a

Congressional Oversight Panel tasked with reviewing financial markets and regulatory systems. And we have all probably heard that the FDIC limit on insurance for deposits at banks has been increased from \$100,000 to \$250,000.

Accepting that this Act is supposed to help the US Economy, why have markets fallen over the past two days?

The financial benefits to the US will be realized over time. The money to be used to buy mortgage assets from financial institutions has not begun to flow yet. And, once it does it will still take time to work its through markets. It took us some time to create this problem and it will take us some time to work out of it.

Was this the best option?

Some have questioned that. But, given that we only had one viable proposal before the Congress and that we have national elections in four weeks, there was not enough time to go back to the drawing board. And, if we had waited until after the elections, we would have been cleaning up a much larger mess.

How do this crisis and the Emergency Economic Stabilization Act affect world markets?

Two important factors that contribute to the spreading of this crisis outside our boundaries are that US financial markets comprise about one half of the world's financial markets and markets around the world are more closely related than before. Governments and companies around the world invest and trade around the world. Just this morning six central banks including the US, UK, Canada, and the European Central Bank acted in concert by cutting lending rates by one half point.