

## MELTDOWN ROUNDTABLE TRANSCRIPT

### Local experts discuss financial crisis

Staying on top of the ongoing financial crisis has become a full-time job.

In an attempt to flush some confusion out of the complex situation, the *Business Report* gathered five experts in the economics and finance fields for a conversation on Oct. 1.

These panelists discussed topics ranging from the history of the crisis to the politics that is entwined in it:

- John Clinebell, professor of finance at the University of Northern Colorado
- John W. Green, regional economist and editor of the quarterly Northern Colorado Economic Report
- Mark Kross, president of Larimer Bank of Commerce
- Ronnie Phillips, professor of economics at Colorado State University
- Julie Piepho, vice president of Cornerstone Mortgage and chair of the Colorado Mortgage Lenders Association

*NCBR* Banking Reporter Kristen Tatti moderated the hour-long session.

An [edited text version of the discussion](#) is available as is an [audio version of the 75-minute discussion in .MP3 format \(35 MB\)](#).

**KRISTEN TATTI:** What set the wheels in motion to get us to this point? Do you think there was a particular event that signaled that we were getting to the point of crisis?

**RONNIE PHILLIPS:** I think a lot of people, around 2002, 2003, started pointing out that the Federal Reserve was keeping interest rates at historically very low rates, the Federal Funds rate at 1 percent — it might have even gotten below 1 percent for a while. That's one thing, the expansive monetary policy through 2004.

**JOHN GREEN:** The money supply grew at 16, 17 percent a year.

**RP:** And a lot of people pointed this out; where was this money going? And I think the other thing that has created problems is the more than doubling of deficit spending by the federal government, which has served to depreciate the dollar, which is going to have some long-term implications. And I think starting with some problems with the Gramm-Leach-Bliley Act of 1999 in terms of regulatory failures and in terms of how things have worked out.

**MARK KROSS:** The way I see it, there are about five or six things that — and I'm not getting into the overall economy, but more the crisis at hand — I think it started with the government wanting to have more homeownership. This is a good goal. The government pushed on Fannie Mae and Freddie Mac to loosen their standards and get better homeownership. This has been accomplished. We have record homeowner percentages today and that's a good thing, it's not bad. Then the regulators involved in Fannie Mae

and Freddie Mac had very little regulatory authority and ability to regulate those institutions, so you had minimal oversight.

You had a business model that in our industry, in the lending industry, that is a little bit risky. You have a lot of folks out there making loans that are separate from the same people who will have to collect those loans. You're originating loans with people who won't be responsible for whether or not those loans are paid back, and in that set of circumstances it's all based on the fact that you have Fannie Mae that will guarantee those loans, you have institutions that will package those loans, and then pension funds and trusts and big things that will buy those loans, and as long as that system works, things work pretty well.

And then, over my 15-year career, underwriting standards — to illustrate what underwriting standards did during that timeframe, when I started my career in 1991, in order to get a mortgage loan on a house and be Fannie Mae and Freddie Mac guaranteed, you had to have about 20 percent down or you had to have mortgage insurance. Then you had to have debt-to-income of about 36 percent, and you had to have good credit. By the time you get to the 2006 to 2007 timeframe, you're looking at mortgage loans being down with zero money down, people with bankruptcies within the last six months were getting loans, there were stated income loans, so you didn't have to prove any income at all. So you went from pretty reasonable to pretty unreasonable.

Then, for a long time, the real estate market covered that up. You had increasing prices, a healthy real estate market, and as you suggested, the money supply helped that process along. Good markets cover up a lot of mistakes. And once that real estate market turned the corner, once you got too many houses and you hit the oversupply limit, then that's really the turning point in this whole thing. With too many houses on the market, the prices of houses started to fall, then it wasn't so easy to get out of a mortgage and it wasn't so easy to sell your house and make money.

Then foreclosures started and that meant the free flow of credit between Freddie Mac, Fannie Mae and the investment banks, the buyers of these credits, the pension funds and so forth, just quit. They just didn't want to buy the mortgage-backed securities anymore. That happened about a year ago, when that all shut down. They would pool these mortgages together, and a lot of them got stuck holding mortgages that they shouldn't have had — that they didn't intend to have. They intended to sell them to somebody else, and they got stuck holding them when the market shut down.

Well, a lot of those companies had borrowed up to 95 percent of the money to fund those mortgages, and they borrowed it from 10 other financial institutions and now we have interlocking relationships that have led to this crisis. Because Bear Sterns owed a lot of people a lot of money and they couldn't sell the assets they needed to sell to raise the capital to meet their obligations and so they were bailed out.

And this is happening over and over again, because you have these assets that people can't get rid of but they need to get rid of because they borrowed on them short in order to sell them. It's sort of like having excess inventory and it has to work its way through the system before it goes away.

**JOHN CLINEBELL:** There's also been a real disconnect between valuing the securities based on the risk that they have versus the perception of risk. Because what's happened — and it's probably from the mid-'90s, when you started having the tech bubble with so

much money flowing in to the economic system — and you were talking about the growth in the money supply, and Fannie and Freddie especially, with pushing from the government as well, going out to expand the number of borrowers, which as you said is a good goal. If you look at what happened, there were a lot of good intentions behind it.

But you have government-sponsored enterprises buying and packaging these mortgages and creating some of these credit derivatives that they were using and splitting them up in all different ways — combining good mortgages with bad mortgages, principal-only derivatives, interest-only derivatives, part of the principal/part of the interest, etc. — and some of those were very risky.

But with the growth in the real estate market, it's no big deal — real estate prices are going up, it's not an issue — and the fact that it was a government-sponsored enterprise that was so involved in this, most investors, from a financial perspective, view the activities and the securities, the mortgage-backed securities, issued by these GSEs as being relatively low risk, which was totally false. So the valuation of the securities was all messed up, I mean big-time, because people thought this is safe, it's government-backed. And so you have a real disconnect, and with just the loosening of credit, even if you look at some of the foreclosure rates now, given the riskiness of those loans, it's probably perfectly appropriate. The problem was they weren't priced correctly.

#### **[GENERAL AGREEMENT]**

**JC:** And now the secondary market for those securities dried up. The price is what it is, but there isn't any market for these market-backed securities — no one wants to buy them. Since no one wants to buy them, then you get into some of the accounting stuff that's going on, messing up the balance sheets ...

**JG:** And covering it up was foreign investors, buying the bonds and the paper of the banks and Freddie and Fannie. So we thought things were going along OK, because somebody was buying those things, so it went on for a year or two longer than it would have otherwise, because we were flooding the world with dollars and those dollars were flowing back in as securities purchases.

**JC:** And as you said, the interest rates are so abnormally low, and have been — it was interesting how much the LIBOR jumped, from 3 something to 6.85 percent, almost overnight. Historically, Treasury bills go around 3 to 4 percent, if you look at long-term averages, about what LIBOR was, and now it's running about half — 2 percent, if that. I'm actually surprised we haven't seen interest rates jump up more even in the last few weeks.

**JG:** But they're still flooding the market with dollars, pushing the money out there.

**RP:** And that's not over yet.

**JULIE PIEPHO:** (Mortgages) will still be \$1.9 trillion this year, which is going to be the eighth largest year ever in United States history, so in the end, mortgage lending is still out there.

**JG:** But the early warning sign should have been the slowdown in the construction industry, because the construction industry saw the decreasing demand before these other signals triggered our interest.

**JP:** When Lennar and some of the other builders here in Colorado started pulling out about a year and a half ago.

**JC:** For me, the warning sign for real estate was when you started to see shows on TLC about ‘Flip This House’ and make lots of money. As soon as I saw that, I thought, ‘Hmm. The real estate market is going to soften and go down.’

**[MUCH LAUGHTER]**

A basic investment strategy should be once the popular press starts saying, ‘Oh, this is what you should do,’ you’re in trouble.

**RP:** I’ve been thinking for years there was going to be a problem, but for me, when Norlarco Credit Union went under, that should be a signal to everybody in Fort Collins: What the heck is going on? And I still don’t know what’s going on with that because nobody’s gone to jail yet. For a credit union to be loaning like that, it’s criminal.

**JP:** I worked for a savings and loan up in Wyoming, and when we tried out our expanded authority, we started making loans in California and Arizona, and when we started going under and you went and saw those properties, there was fraud on appraisals, we were making loans on dirt, we were doing the good-old-boy — GOB — loans, that type of thing. Look at Norlarco. We’ve done the cycle and we haven’t learned anything.

**RP:** It used to be, oh, credit unions, they’re so safe ...

**JG:** ... if they’re tightly enough regulated ...

**RP:** That’s where it becomes apparent that the NCUA is no regulator at all, evidently. I’m surprised more people didn’t pull their money out of credit unions after that.

**JC:** What I found interesting was how compensation packages were changed and restructured. In the real estate area, but in all of the loan areas, people were being compensated on the size and number of the loans they made, not on the quality of the loans, they weren’t on salary. The more you can give, the better – you want a \$100,000 loan, but I’ll give you \$200,000 because I get a bigger commission off of it.

A student of mine went to work in Chicago selling mortgages. And he was pressured — that’s how he made money, that’s what he was told to do. I mean, it was wrong, and he talked to me about it and said, ‘I know this is wrong.’ He left the business after about 6 months because he didn’t feel comfortable with some of the mortgages that he was actually giving to people.

**MK:** It was a risky business model, and it's risky because you have people who are making loans who won't actually be responsible for actually keeping them. It's not that that business model can't work and can't be effective, and it's not that providing good incentives to people to do a good job is a bad thing, it's just that it didn't have the regulatory oversight that, for example, the banking industry has.

The banking industry in the United States is extremely healthy. I know there are people out there going, 'You're crazy,' but it is. The commercial banking industry is healthy. The investment banking industry is totally different. Commercial banks aren't in bad shape at all. I know that comes as a surprise to a lot of people because it comes as a surprise to our customers.

**JG:** That's why Wells Fargo's not been affected much.

**MK:** No, not much. And local banks are in great shape. Our local economy is in better shape than the national economy, and our real estate market's much better than the national. We didn't participate in the upside of this particular run-up in prices, and we aren't participating in the downside as much.

**JG:** Moderation on the upside usually means moderation on the downside.

**MK:** If you look at the banking industry today, there's 8,465 banks in the United States, and only 117 of those are in the category of troubled. Only about 120 more have what they call just fair equity, they are just fairly capitalized, so 98.7 percent of all banks in the United States today are well capitalized, meaning they have more than 10 percent capital. Average reserve for loan loss is 1.2 times. Our industry loss over the last 30 years is less than one-half of 1 percent.

Working in this industry — the traditional commercial banking industry — I have seen the credit standards loosen slightly in the last 15 years. And there are not the problems as a result. You have ancillary problems, like lenders that have lent to construction companies that are struggling, developers, things of that nature, and that kind of ebbs and flows with the economy. When a certain segment of your customer base has trouble, you're going to struggle a bit. Some banks have more exposure to that and some less, and we're lucky enough to have minimal exposure to that.

**JG:** How many banks do we have on the troubled list in Northern Colorado? Three?

**KT:** I've seen a couple pop up in some analyses, but they don't let us know who's on the FDIC list.

**RP:** I did spend sometime with the OCC and the FDIC. The OCC has been around for almost 150 years. The OCC and the FDIC examiners are very good. You did have some lessons learned from the 1980s and the early '90s, and you had the FDIC improvement acts, and the commercial banking system is what you should probably have the most confidence in. These other things, I don't know about ....

**JC:** And the regulators who were regulating weren't very good.

**RP:** I don't know about that, but they didn't have any power.

**JC:** It's not just the regulation, because you need some regulation to make sure you take care of some of the fraudulent practices. But a lot of it was the mispricing of these securities when people were buying them and thinking that the government was backing them when there was really a lot of risk associated with them. People perceived Fannie and Freddie as fully backed securities.

What Fannie and Freddie were originally designed for, and then they kind of expanded out, their job was to provide liquidity to banks by buying up their mortgages so the bank didn't have to hold them, create their mortgage-backed securities, pass those through to other individuals, and, historically, when you had the tight lending standards, it was no problem. When they got into all the subprime and very high-risk securities, people didn't value those as high-risk because they were coming from Fannie and Freddie and going through this whole process. And most of them were passing through Fannie and Freddie at some stage.

**JP:** There were a number of private securities on the subprime market that weren't passing through Fannie and Freddie.

**JC:** But people would group these together ...

**RP:** Take some bad and some good and they should all be good, right?

**JG:** Average risk.

**JC:** Right. The average risk is really good here, because the government wouldn't let Fannie and Freddie do this if it was really bad or risky.

**MK:** I think what happened in that circumstance is that you had statistics, and you look back at the mortgage industry and one of the safest loans that could be made was a loan on someone's personal residence. The default rates on those are very, very low when you look back 25, 30 years — under standard underwriting terms, which meant the person could afford the home, they had money down, and they had good credit history. When those circumstances were met, mortgage loans were some of the safest ones you could do.

What I think must have occurred is that people would say, 'Well, with all those standards, it's a third of 1 percent default rate on these types of things, so wouldn't it just be three times that if we had real loose standards?' And they built these models based on that idea, and the rating agencies actually rated a lot of these mortgage pools as triple A. They rated them very, very high, so the buyers of these things weren't aware of the risk.

We'd never tried this on a mass scale in this country: If you loosen standards tremendously, how many will go bad? I think we we're learning that lesson, I think now we'll have good statistics on it. Good underwriting practices led to low default rates. I think they determined that, well, people just won't lose their houses, and that's not the case.

**JG:** Because they didn't think the price would go down. Then when the price did go down, they misestimated the number of people who were willing to walk away from their house.

**MK:** That's the other thing that always happens in every one of these bubbles that we have — people think, 'It's different this time.' It's always 'different this time.' It's never different; it always ends the same way. We're all people, and people do the same things again.

**KT:** So how is this the same or different from the savings and loan crisis or the Great Depression?

**RP:** The FDIC had this symposium in 1997: 'Lessons for the Future.'

**[GENERAL HILARITY]**

**JC:** When is that? Next week?

**RP:** (In the report of the proceedings of the symposium), William Siedman wrote, among other things: 'Our third lesson is that the biggest danger for financial institutions is lending based on excessive optimism generated by certain kinds of lending that are the fashion of the day.' Whoops.

**MK:** Again, the people who came out with that book regulate the banking industry. They have authority and power in the banking industry to stop practices that are unsafe and unsound, and they do. And for the most part, other than a few minor exceptions — which are more the exception than the rule — the banking industry is very healthy as a result of good regulation, and regulators who have the authority to come in. And good practices, because they have a history in this and they know what things work and what doesn't work.

**JG:** Regulators can be told to back off. For example, my last job was working with the Animal and Plant Inspection Service and we were told, literally, our management was told to back off regulation in the industry because it was the view of the current administration that the market should be let to operate more freely.

**JP:** I think the big key to regulation is enforcement. We've got all this regulation out there, and I think about the OCC. I've been involved with the OCC — not working for them — but you think about the OCC-regulated WaMu and IndyMac and look what happened with that. The OCC regulators don't have a clue how to manage the mortgage side of the banking business at all. They just don't understand mortgage-backed securities, they don't understand the compensation. I disagree with the risky model on the compensation package, I definitely disagree with that.

**JG:** They don't collect the statistics so they can know, because they're told to don't interfere.

**JP:** That's exactly right. And they truly don't have a clue. The training on the mortgage side is appalling.

**RP:** I know that at the OCC, when the bank examiners go out, they go out with PhD economists — or in finance — who are supposed to understand all of these derivatives that the bank examiners don't. And I know for these large banks there is a group of bank examiners and economists who are assigned to that bank. So, they're supposed to know. Now, it was a problem during the 1980s and '90s that members of Congress might try to influence the regulators, so I don't know if it's a problem with the bank examiners, but there might still be a problem with what the bank examiners are saying. We don't really know in terms of the failing banks if we don't have the CAMELS ratings, but the regulators still have some discretion. But I think that's been reduced, again, for commercial banks.

**MK:** Washington Mutual and IndyMac really aren't commercial banks. Yes, they had those charters, but they got those charters later, and they really were mortgage originators. And their real problem was just like the investment banks, they were packaging loans, and they got stuck when the market shut off and nobody would buy them and they got stuck holding what was in the middle. You can't regulate that type industry the exact same way you can a commercial bank, because a commercial bank holds a loan for a long time, and if they're making mistakes, you're going to see it. When loans are constantly flowing through, well, how do you know which ones are good and which ones aren't? And how do you know when the market's going to shut off?

**JG:** And why do you care, because it's gone tomorrow.

**MK:** It's gone tomorrow, absolutely. So I think a blind eye is turned to that to some degree, because some of these loans are only on the books for 30 or 60 days.

**RP:** And WaMu was a savings institution, right? (Regulated by) the Office of Thrift Supervision. Now, that's a different story. Remember, the OCC and the OTS — bureaus of the Treasury — where do they get their revenue to fund their bank examinations? It's from fees paid by the banks. OK, what's OTS looking at? After the savings and loan debacle, a lot of institutions shifted to bank charters. We've been trying to get rid of the OTS for, well, since they created the OTS, basically, because of this problem. You still have a savings bank charter and that's different from a commercial bank charter, and I think that's important to point out, too. Those two were savings banks, not commercial banks. How was the OCC involved in either WaMu or IndyMac? I don't think they were. The FDIC was involved, and it did concern me a little bit that there seemed to be some problems with IndyMac in terms of how the FDIC was communicating, because generally, the FDIC is the model of what you do when you close a bank. You come in and you shut it down.

**JG:** In one night, and open it the next day, and everything's all arranged.

**RP:** That's right. That's what really got me about the Norlarco thing, they said, 'We're going to close it, but we're going to keep it a secret.' You're not going to keep it a secret, because people are going to look and see that people with insider information withdrew their deposits.

**JG:** Then we're going to have people bid openly on who takes it over.

**KT:** What is changing now? What are they trying to do with the bailout? And what does that mean for the different sectors?

**JG:** Mark, I think the question that's been raised in my mind as we talk about the bailout is: Is the bailout really going to help commercial banks? Or are commercial banks OK and maybe we shouldn't have a bailout? We'll go through a tough time but the commercial banks will pull the country out of this problem because of their relative good health?

**MK:** There are many facets to that question, which makes it difficult to answer all at once. I've seen some differences in how we operate and how things are going. People talk about the differences between Wall Street and Main Street, and we operate on Main Street. There are some differences, but we are lending money, a lot of our competitors are still lending money. It's not a whole lot different in my world than it has been.

If I look at my own personal experience of what's happening in my business and what's happening in Northern Colorado, I would think, well, you don't need a bailout, everything's working, things are going OK. We're loaning money, other people are loaning money, there's demand, people buying things, there's distressed properties being bought by investors – the market is working.

Now, when I hear the explanation of why you need this bailout package, because of the credit freeze, that makes a lot of sense to me too. I'm not seeing it personally, which is why I think this is very unpopular. This really hasn't been communicated or understood very much by the public, and I don't think a lot of people are seeing the issues as seriously as what we're hearing about them on the news: Boy, this is the worst thing since the Great Depression. People talk about the Great Depression — I obviously wasn't anywhere near living at that time — but this doesn't seem like it's that bad.

Now, on the other hand, I understand all these commingling relationships with banks and no confidence in the system. I truly believe that there is a lot of weak confidence, I see that a little bit on a daily basis, because we're getting deposits from solid organizations that have no issues at all but people are moving their deposits to get \$100,000 FDIC insurance from our bank. From a perfectly good bank they'll move their deposits around and in the last 6 months almost every day I've heard someone want to understand what the FDIC limits are. I went 10 years in my career and it wasn't a big issue. I didn't need to know a whole lot about it because nobody really cared. And in the last 6 months, a lot of people care. But it's perception rather than reality, because a lot of the banks people are moving their deposits from to our bank are perfectly healthy, there's no issues with them.

**JP:** I think fear is a huge factor right now. I think fear is just overriding the country, and I think that's what's happening. I've heard of two instances in the last week, real-life instances, where a stockbroker called a client and said, 'cash out all your securities, take out all your money in the bank and take it home and put it in the mattress.' True story. So, it's that perception of fear that's also driving the run on the banks. And I think the press and unfortunately even our President is causing that to happen.

**JC:** Oh, definitely. The bailout itself, if you look at it, is primarily psychological. Just like now, a big part of what they're talking about is upping the FDIC limit to \$250,000, and even one proposal was to just make it unlimited. So a lot of it is purely psychological.

Of course the markets, the economy, is driven by psychology, because if everybody stops buying and takes all their money out of the banks and out of the markets, it goes to pot. There is also a fundamental issue where they are trying to provide some liquidity to the secondary market that has kind of gotten stuck.

By the way, credit freeze, to me, is a total misnomer. It's not true. I mean, credit has tightened but it hasn't totally frozen. Corporations can still get money. Now, again, it's tightened – it's going almost back to where it was 15 or 20 years ago – but we've gotten used to, in our system, loose credit, low interest rates, easy credit. That's hyped.

Now, we're kind of walking this tightrope of how do we make sure we're still giving people credit but we don't go too crazy and it's too loose but how do we reassure people? What drives me crazy as a finance person: the 777.68 drop in the market on Monday (Sept. 29), in the news media — 'this is the Great Depression, it's Black Monday of October '29 all over again, it's the worst thing that's ever happened.' The first thing I said to my students was: This isn't even in the top 10 of one-day drops. I doubt it's even in the top 15 of one-day drops. percentage-wise. That's all that matters — the percent. Points are meaningless. The Dow is a simple weighted average — you add up those 30 stock prices and divide by .123472865 — that's close — and adjust for stock splits. The total number doesn't matter, but that's what they focused on. I heard supposed financial experts telling people, 'get out of the market!' Panic, when really, when the market drops 700 points is probably one of the best buying opportunities you have.

**JG:** That's when I bought.

**JC:** I think it wound up like 17th as far as percentage drop.

**MK:** When the market crashed in October 1987, a 24 percent drop, the next day was the biggest point gain ever.

**JC:** It took about 4 or 5 months to recover from a 24 percent drop ...

**JG:** But it was back to where it was in about 4 months.

**MK:** I don't see any difference this time.

**JP:** On the mortgage side in the last year, we've seen over 800 'products,' if you will, completely go away, from the wholesale correspondent side of business of the loans. And you've seen a lot of the major investors quit doing wholesale, you still have them doing correspondent. But the market regulated itself, before the regulators even came in and regulated it.

Today, we can't do a no-asset, no-income loan – no NINJA loans. It's funny, but Chase has a product out there that is 103 percent to try to help the first-time homebuyer, but guess what? Our warehouse bank won't let us do it because we can't give a 103-percent loan. So you still have a lot of gaps in the market. I don't want to go so far as to say use intermediation – there's still the demand here, the regulators are over here, and the investors are right here, and they still haven't come together to figure out what they're going to do about the mortgage market.

**MK:** The free flow of credit has certainly slowed. Some of it may be necessary, but there's no question when the flow of credit slows down, when money gets tighter, it's harder for the economy to grow, it's harder for jobs to be created, and the chances of going into a recession or having an economic downturn are increased, there's no question. At this point, I'm not sure even a bailout plan will change that. But this is a normal part of our business cycle, too, to some degree. I hope there's nothing permanent with it, I hope we can come back and get back to normal.

**JC:** A lot of its psychological as well, and it's exacerbated simply because we're in a political season. But the economy has been talked down for a year or more. In the fourth quarter of last year, we had a contraction in the economy — very slight, I think -0.2 in the fourth quarter. In the first quarter, the economy started rebounding, grew at 0.8 percent; second quarter, initial estimates were at 3.3 percent, actually relatively high growth. But some of that was due to the stimulus package. Unemployment is about 6 percent; that's a lagging indicator anyway. If you look at some of the basics within the economy, this is not that dire, depressive era where you have 25 percent unemployment and things like that. But people compare it to the Great Depression. It's not even close.

**RP:** It's nowhere even close; however, I think there is an important lesson about how the system was saved in the 1930s that people have forgotten about. Under the Hoover administration they created the Reconstruction Finance Corp. And under Hoover for 1932, it made some loans to industry. When Roosevelt came into office, through the Emergency Banking Act of 1933, they expanded the authority of the Reconstruction Finance Corp. to buy preferred stock in banks. By 1935 — remember we didn't have temporary deposit insurance until 1934 and no permanent federal deposit insurance until July 1, 1935 — by July 1, 1935 the Reconstruction Finance Corp. was a part-owner — owned stock — in one-half the banks in the United States, and one-third of the total bank capital outstanding was owned by the Reconstruction Finance Corp. We had nationalized the banking system.

Now, after the recovery — a period of 10 years, I believe, probably after World War II — of course the RFC was eventually dissolved and they got rid of the preferred stock. They sold it back to the private sector and deposited the profits in the Treasury. So we did nationalize the banking system.

That's what we've done with Fannie and Freddie. We've nationalized Fannie and Freddie. I also would point out that Fannie was first a government-owned corporation. In 1938, it was a government-owned corporation. So when was it privatized? In 1968. The problem with a government-owned corporation is its debt is on-budget. Lyndon Johnson says, "We're going to have this huge deficit unless I find some way to balance the books." So the Johnson administration and Congress they privatize, make a GSE, out of Fannie. The Nixon administration in 1970 said Fannie needs some competition so let's create Freddie. And that's the problem.

**MK:** Which part of it?

**RP:** I think the problem is having it as a GSE. Because a GSE means private ownership, so private profits. But if it gets in trouble there's an implicit government safety.

**JC:** And that gets back to that disconnect of risk with return.

**RP:** That's right. What should be done with Fannie and Freddie is, once things recover, they should be totally privatized. They should get rid of that GSE model.

**JC:** Or totally nationalized. It's got to be one or the other. Either a straight government agency or it's got to be private. These quasi-things, I think, are ridiculous.

**MK:** I think you guys are 100 percent right with that.

**JG:** So, the bailout will create a Reconstruction Finance Corp., in the modern terms, that will do this?

**RP:** I think that's what they should do. But they haven't really set up something like that. They're going to have the Treasury do it. Well, the Reconstruction Finance Corp. was of course under the Treasury Department, but they haven't done it here. It's what they really need to do. They had this guy Jesse Jones. They could have Warren Buffet and some people selected to run it.

**MK:** What about the preferred stock idea? I've heard it come up a few times, where they would basically loan money to these institutions and take preferred stock in them.

**JC:** Again, it gets back to what's the purpose here. What the original purpose was, to look at it, was really two-pronged. One, which to me was the major issue, was to address the psychological concerns in the credit markets — that the government was going to make sure the credit markets still operated. But number two was to provide some liquidity to these illiquid securities that no one would buy anymore because the secondary market dried up.

So as opposed to let us infuse a lot of capital and get preferred stock and give the bank's money, that wasn't the purpose at all. The purpose of the bailout was to say, "Listen, what we will do is we will buy some of these securities that no one else will buy." In other words, we're going to create the liquidity. And then hopefully if it works out well

— because these are way underpriced, unless Paulson and the folks at the Treasury really screw it up, they should get a really good deal — it would give some capital inflows and allow a loosening of the credit market. And then turn around a few years down the road and just sell the securities.

In a way, to simplify it, it's almost like the stock has dropped way down and we're going to buy some of the stock and turn around and sell it. But it wasn't to just give money to them. It's to buy this illiquid asset and turn around and resell it.

**MK:** I worry. I don't have as much experience as a lot of people in the room, but I've seen very few things the government has done that work very well. I think that's kind of the reluctance about this whole thing. Would they do as good a job doing this as it could be done by the market or the private sector or some other place? I haven't had a lot of great experience seeing the government do great things. On the other hand, my understanding is with the savings and loan debacle with the RTC they did actually did fairly well.

**JP:** Because it was a direct infusion of capital.

**RP:** The Resolution Trust Corp. from the 1980s is another thing they need to revive, basically. If you look at it, the RFC is a government-run corporation, but you can put Warren Buffet, or someone like that, in charge of it. The guy who was in charge of the RFC, Jesse Jones, he spent the government money like it was his own. So it was that sort of personality.

The other thing I was going to say about the 1930s is what stopped the bank runs is that Franklin Roosevelt went on the radio and he explained to people the way our banking system works. He said, 'We're going to open the good banks, we're going to close the bad banks and the others we'll open after a while.' In one week you're going to examine the 30,000 banks in the United States? No, they didn't, but they stopped the bank runs. During that time, with provisions of the Emergency Banking Act, the Federal Reserve could loan against any eligible asset — basically anything on a bank balance sheet. They ran the printing press, just like they did for Y2K, and dispersed the Federal Reserve notes out to the banks and they were ready for the bank runs.

I had someone call me and say, 'Should I take my money out of the bank?' I said everybody can take 100 percent of their deposits out of the bank and I'll bet you they would still have enough fed reserve notes to pay you off because they still have some left from Y2K.

**JP:** You know, Ronnie, what you're saying about Roosevelt, it's so true about leadership. We need some leadership right now in our country that would take care of some of this fear. If our President came out today or Congress came out today and said we have this model, we believe it will work, and you do not need to be afraid, I think a lot of this would calm back down, because there is credit; there is money.

**JC:** Actually, if this had occurred a year ago, it would have been done. It would have been taken care of. There would have been some model put in place. It wouldn't have

been any big deal, as far as getting the bailout in place. Or the rescue, whatever you want to call it.

**JG:** So if we don't have a bailout, how is the banking system as it exists going to solve this problem over time?

**MK:** Like I answered before, it's very hard to get at. When I look at the way things are working now and what I see in my experience working every day in the banking industry, I see that things are a little tight and it's a little nerve-wracking, but it's working.

But does that just mean it hasn't spread to Main Street yet? If things go as they have in the past, I don't see a problem. If you do see things spreading to Main Street, you do have people that pulling money out of the banks that are perfectly healthy and you do see institutions fail that shouldn't. Those types of things you worry about. That's the fear factor I would have.

**JG:** So is do nothing a temporary solution to this?

**MK:** Oh, absolutely. There is no reason to pass this in the next day or two or whatever. There seems to be a huge sense of urgency.

*(Editor's note: This conversation took place two days before President Bush signed the Troubled Asset Relief Program into law.)*

When I hear them describe that no one can get a loan — you can't get a car loan, you can't get a house loan — I'm not seeing that. I'm seeing that people are getting loans all the time.

**JC:** What you'd see is more tightening in the credit market. You'd see a few more hits on the Dow. As I've said, we still have a way to go before we get into some of our big drops. Again, it's really more psychological. The market will work its way through, but you'll see a lot of tightening up.

And then you get into the whole issue of do we want to tighten the credit up that much or do we want to still make credit available to low-income individuals? You get into the social policy side of it, which is part of what you do. That's really what their goal is: How do we keep the credit markets loose? You could argue and debate whether or not that's the best course of action or the worst course of action. The key is to understand what they're trying to achieve and whether what they propose comes close.

**MK:** It seems like they're trying to calm the markets to some degree. Obviously, I think there is a lot of political stuffiness. If you look at how people voted in the House on the stimulus package, what it looked like to me is that it didn't matter if you were a Democrat or a Republican. You voted no if you were in a close race and you were able to vote yes if you weren't. If you look at the Colorado folks, the people who have no chance of losing voted yes, whether they were a Democrat or Republican. The people who voted no voted no because they were in tight races.

**JC:** The other misnomer is this is a Wall Street bailout. It has absolutely nothing to do with investors, Wall Street, the brokerage firms — as far as handling the transactions — and people investing and buying and selling stocks, other than how investors are reacting to what they think the long-term impacts will be on the society. It's a credit market issue, not an investment issue.

**MK:** When people on the news say it's all about Wall Street greed ...

**JC:** That's not true either. Well, there is some truth to it. The whole crisis to me is one of these things that was brought on by a combination of good intentions — what's the saying? The pathway to Hell is paved with good intentions? Good intentions — let's bring in these people that haven't been able to borrow before and get them into housing, which is a good objective — some stupidity, by the government and by investors ...

**MK:** And by the industry.

**JC:** Because we have these GSE, government-sponsored enterprises, out there that didn't really know how to handle all of this looser credit.

**JP:** And they had low- to moderate-income goals that they had to fulfill.

**JC:** You have a little bit of fraud and corruption.

**JP:** But not as much as everyone believes there is.

**JC:** Everyone thinks the whole problem was driven by that, but it's not.

**RP:** It's the same with the S&Ls. You point to Charles Keating and say it's because of people like Keating. Well, no. It was the way the system was structured.

**MK:** Some of it is just capitalism at work. You have people who are incentivized to do mortgages, and they have rules. They don't get to make the decisions on the mortgages and they just work hard to get them done. Even the Wall Street packages, they didn't make a lot of money on each individual mortgage that they sold. In fact, the margins were very, very thin. It's just the huge volume that made it all go.

**RP:** I think it's not good when Congress is rushed to do something. I would first blame the President and the Secretary of the Treasury. Sending a two-and-a-half page thing — Roosevelt could get away with that. When they passed the Emergency Banking Act, Congress hadn't even read it. They didn't have copies printed up. They said here it is and everyone voted for it — well, I don't know if it was everybody.

What I would be concerned about is, by doing these things without thinking about them for a while, they are pushing the system more toward nationalization, but not nationalization of the Reconstruction Finance Corp. and Jesse Jones running it. It's, I don't know, someone in the Treasury somewhere. They're pushing nationalization without thinking about what that really means and that's really dangerous.

**JC:** They've moved very quickly because of their concerns. Although, I'll have to be honest, in some ways I much prefer a two-page bill being passed through Congress than a 500-page bill that no one understands and half of them never read.

**RP:** Unfortunately, the two-and-a-half pages says, 'Just trust us'. Like I said, Roosevelt got away with that, but Bush can't get away with 'trust us' on \$700 billion.

**JG:** Or a 20 percent approval rating.

**JC:** Let's be fair to him, because the Bush administration pushed to really oversee and do some work to try and fix Freddie and Fannie about five or six years ago. They brought it up to Congress. They wanted to change some of the regulations; change how it was regulated, some of the stuff we've already talked about, in 2002, 2003, 2004 and 2005. They actually did push some of that.

**MK:** And amid some serious opposition in doing that. On the other hand, it's the whole mess of blame, because even though one group was supporting keeping it the way it was and one was saying we should look at changing it, at the end of the day neither one of them did anything.

**JC:** They were all at fault to some extent

**JP:** I've been lobbying every year for five years in Washington for greater oversight on GSE — every flipping year for over five years. For all of our Colorado people, that was one of the three things I would ask for every year. But it wasn't very important because we had the appreciation, the market was good and real estate was doing great. So it wasn't a priority for them.

**RP:** I have a good friend who works for OFHEO. Almost no one knows that is the agency that regulates Fannie and Freddie — the Office of Federal Housing and Enterprise Oversight. I have a good friend, he and another colleague at OFHEO wrote an article five years ago about Fannie and Freddie: 'Too big to fail.' They were going to publish this. OFHEO would not allow them to publish it under their names. So I have the article published in a book under someone else's name. There's a little asterisk; the names of the authors are withheld. How many times do you see that in an academic publication? The names of the original authors are withheld. Now, he's looking pretty good. They said they were going to fire him. This is a guy who worked for the Congressional Budget Office during the S&L debacle. Then he worked for the OCC. And now he's working for OFHEO, and he said there was a problem. So lots of people were saying it. People within OFHEO were saying it but they couldn't do anything.

**KT:** I guess one of the final questions is, what does the industry look like after this?

**RP:** Well, what it looks like is a very small number of financial — I think they have to be financial holding companies under Gramm-Leach. So you've got these very large

institutions that will be really problematic in terms of who is going to regulate them. And then you going to have thousands of other small banks — commercial banks — and that's just fine. I would really be concerned about the future regulation of JPMorgan Chase, Citigroup and all of these.

**JG:** You mean how it's going to be done?

**RP:** Yeah, how is it going to be done, because one of the problems that isn't straightened out is the regulatory structure is a mess. Bush comes out and says, 'Fire the head of the SEC.' Well, what does the Securities and Exchange Commission have to do with it? What is their regulatory authority?

What I would like to see is a clear separation between the agency that deals with liquidity problems and the agency that deals with solvency problems. So I would like to see the Federal Reserve get out of the regulatory business and let the combined FDIC and OCC be responsible for solvency. It sometimes becomes a problem to tell between liquidity and solvency. But the problem with the Federal Reserve is that if there is a problem, they can just loan to you. The Federal Reserve can create money, and the FDIC and the OCC can't. Then you can say where does the SEC fit into all of this and what about the Monetary Futures Trading Corp.?

The regulatory structure needs to be rethought, totally. I don't know whether Congress will do that or not. They can't even get rid of the Office of Thrift Supervision. The regulatory structure is a big mess. And I, for one, am not that crazy about giving more and more authority to the Federal Reserve, because they print money.

**JG:** They really created a problem in the first place by lowering interest rates to 1 percent.

**RP:** Yeah, that's right. So you're going to give them the regulatory authority? I don't think so.

**MK:** You make a really good point. I look at the commercial banks, and the commercial banks I've worked for are relatively small. The regulators who are regulating them have a good handle on things. I don't deal with 20 different regulators. I just deal with one or two, and it's usually at the same time. It works fairly well. So the traditional FDIC and state regulators working in community banks, I think, still makes sense. That model works.

But when you get to these huge organizations you run the risk of if they are regulated by the OCC and some from the SEC and five or six different regulators – who really has the power over all of those things? You can see a little bit of a problem here and a little bit of a problem here and not think it's that serious. But if you put everything together it is that serious.

**RP:** It's true because only the FDIC can close a bank. The Federal Reserve does not have the legal authority to close a bank.

**MK:** Our institutions have changed and molded into something different, whereas the regulators are still looking at the way banks were 20, 30 years ago. And a lot of banks are still like they were 20 to 30 years ago.

**JG:** And that part is working.

**RP:** Congress has to address this. That's the big thing. I would say that what you are looking at down the road, if Citibank and these others get into trouble, you'll have to nationalize them. That's what you're going to have to do unless we get everything else lined up. We've done that before and you'll have to do that again. It's something they had the Reconstruction Finance Corp. do. The FDIC refers to themselves and in the legislation as "The Corporation."

I still know a lot of the economists at the OCC and the FDIC. I think they do a good job in terms of regulation. Credit unions ... If you're worried about the regulatory structure, the National Credit Union Association, I couldn't believe what they are saying.

**JP:** I think we just have to get the whole patchwork of regulation together. And how long has Congress been trying to do that? Forever. I look at the new SAFE Act and look at what it's doing. The SAFE act, on a national level, says you have to do this, but states can do whatever they want as long as they meet the minimum of the SAFE Act. There are states, and I'm afraid Colorado will be one of them, that are going to go up to this next level that's even higher to regulate. And it still isn't doing any good because they are overstepping the boundaries of the federal regulations. I think it's a serious problem.

**JG:** So we might not get anything done if we have a divided White House and Congress?

**JP:** I don't think we will.

**JG:** And even if we don't we still might not get anything done.

**JP:** I don't think they understand. There's too many agencies out there and nobody understands what everybody does and how they interact with each other. I mean, there's only one agency that can close banks, but here's somebody else saying you can do this and this.

**MK:** With the rhetoric you hear coming out of Washington, you would think they really don't get what's happened, what is happening. And these people are going to make the decision and solve this problem for us. It's a challenge, because it doesn't seem like they be able to because they don't get how we got here. At least, from what they say. A lot of it is just pandering.

Everyone is trying to blame it on the other person right now — it's these guys or these guys that did it. You don't know if they really don't know what they're talking about or if they are just trying to play like they don't. They may be smart about it, but they don't want to tell that to their constituents because there isn't any political gain for that.

**JG:** As we said a few minutes ago, some people are getting reelected and others aren't.

**MK:** If you blame it on a group that a majority of people resent and don't like, well, then it's a good thing. So we blame it on Wall Street and say it's these real rich people on Wall Street that are the problem. Well, it really doesn't have a lot to do with that. It isn't the source of it. It isn't why it started. It isn't how it broke. None of it is that way.

**RP:** Even using a 'bailout.' The news media needs to quit using the term bailout, because that isn't what it is. It has to go back to when Bush and Paulson brought it out, I think they said it was a bailout. That's the first thing you got: It was a bailout.

**MK:** With Bush, I don't understand why he would be the one pushing this that hard. He's kind of a lame-duck president. He's not going to be the one around when all of this takes place anyway.

**JG:** But it's his legacy, though.

**MK:** If you look at what is his political motive — is it to get all the Democrats to vote for it so they all look bad? I don't know. Or build his legacy. I'm not sure why he would want to do it. I would think that if you only have a few months left and someone else is really going to be the person to do the nuts and bolts of it, maybe wait a few months until they get around.

**JG:** Until the crash is solved. He's afraid of that. So then he pressures them to solve the problem so it won't crash and he won't get blamed for it.

**MK:** Well, he's been blamed for everything. Some of it is his fault and some of it isn't.

**RP:** The buck stops here.

**MK:** His legacy is going to really build out with the success or failure of his foreign policies and those types of things. It will be years and years before the results of those are known.

**JG:** Unless we have a financial crash

**MK:** And then he gets blamed for that.

**RP:** People talk about Herbert Hoover. Of course, with the Emergency Banking Act, what the deal was, Roosevelt didn't have his Treasury officials in because they had to be confirmed by the senate. The Emergency Banking Act was written by Ogden Mills who was Secretary of the Treasury under Herbert Hoover. They had it ready. Hoover didn't have the guts to close the banks, and the people didn't have any confidence.

If Hoover had tried to close the banks it wouldn't have worked because people had already lost confidence in him. But someone like FDR could pull it off. It doesn't make a big difference, what the president is able to do. Now with Bush, it is almost like if

he can get the Democrats to pass this then they will get the blame. I don't know — it's crazy.