MARKET PERSPECTIVE

by Kevin McTavish

Japan Redux

It's Time to Face Up to the Economic Problem

It was recently reported that Citigroup reached an agreement with lawmakers to grant bankruptcy judges the authority to alter mortgages for homeowners in an effort to halt the avalanche of foreclosures occurring across the country. The provision will be attached to the stimulus package that will be proposed by incoming President Barack Obama and reverse a 1993 ruling by the Supreme Court that prohibits judges from altering mortgages on primary residences.

Not surprisingly, the lending industry is being forced to the table kicking and screaming and is adamantly opposed to the plan. Scott Talbott, chief lobbyist at the Financial Services Roundtable, an organization that represents large banks and insurers, said, "This would hurt the housing market at the exact time we're trying to stimulate it." His view, and that of others who agree with him, is that such a move would actually increase interest rates for homeowners because it will create more uncertainty about the potential losses that banks will incur. The loans eligible for this "cramdown" provision would be limited to those made prior to the signing of the bill and for homeowners who already have attempted to modify their loan.

Even though this may be a worthy effort from an altruist standpoint, in reality this solution is merely window dressing and an attempt at political cover by Congressional lawmakers responsible for the proposal. These are the same folks whose lax oversight paved the way for this problem to begin with. If passed, this solution will be like trying to clean up Hurricane Katrina with a paper towel.

The current financial crisis and mortgage debacle is not going to be resolved one single-family loan at a time. The proposed solution is impractical and basically another act of shameless political grandstanding. Trying to implement it will clog the bankruptcy court system for years. The only group that will benefit from this change are the appraisers and, of course, the attorneys. Not that the lenders don't deserve to be forced to take losses on poorly underwritten mortgages. The lenders lived in utopia for several years leading up to the current mess, making up interest rates, loan-to-value levels, little or no underwriting standards, no accountability and even having the ability to not have their loans crammed down by the courts.

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What is needed now is broad, bold and decisive action. The financial system now suffers from a lack of confidence as extreme as the overconfidence it exhibited through mid-2007. Otherwise, the United States risks encountering the same malaise that Japan experienced for a decade. The current lack of courage on the part of the creators of the problem — politicians, lenders, government regulators — is appalling, but yet there appears to be a lack of outrage by the public and the press.

The latest mantra that seems to be prevalent is that a huge government infrastructure construction program will kick-start the economy and everything will be back to normal. It's as if all of the new spending associated with these government programs will somehow cover up all of the mistakes and inept activities that got us here in the first place. Well, Japan tried this same approach, and it didn't work. For years, Japanese banks refused to write down their loans (partially because there is much more required coordination with the Ministry of Finance and other government influences — banks can't act independently) and failed to address the impaired loan issue. I recall arriving in Tokyo in the late 1990s to set up shop and feast on the anticipated dumping of loans by the Japanese banks. I remember being amazed at the number of construction cranes that could be seen in every direction. It seemed odd that the Japanese economy could be in such dire condition with so much supposed economic activity simultaneously taking place. It turned out that a lot of the construction was on government-sponsored projects. But much like the current situation in the United States, the Japanese lacked the political will to pick winners and losers, to call out those responsible for the problems and take actions to rectify the problems that ground their financial system to a halt.

The United States appears to be following in the same footsteps of the Japanese. It is widely acknowledged that there are massive amounts of bad loans sitting on the books of banks and insurance companies, but little has been done to force these institutions to move these assets off their balance sheets. It is becoming apparent that they won't voluntarily take the hard steps and fix the problems unprompted. Rarely do institutions have the courage to act on their own — especially when the actions will result in exposing themselves and/or having to incur some pain. And the same politicians and regulators who were complicit in the easing of the regulations to create the current environment aren't exactly rushing to take the lead to mount the effort needed to administer the tough love needed for the cleanup. Until somebody is willing to take on the cozy relationship between the financial institutions and those who supposedly regulate them, it is unlikely that any meaningful action will be taken to create a permanent solution.

A continual application of bandages isn't the solution when major surgery is needed.

The lesson learned from Japan should be that partial solutions not only don't solve the problem but have the potential to prolong and exacerbate the situation. On the positive side, the United States has its own experience with the Savings & Loan industry clean-up as an example where a decisive, take-no-prisoners approach dealt with the problem head on and solved the problem within a decade.

Initially we were told that the TARP money was going to be used to purchase troubled assets from the banks and insurance companies. It sounded like a reincarnation of the RTC was being formed — which wasn't a bad thing. At least the problems would be identified, the institutions' balance sheets would be made sound, and the lending environment would move back toward normalcy. Instead, the government has taken a random, reactive approach that risks prolonging an already deep and systemic problem. ❖

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