$700 Billion

Trying to save the Titanic with a paper cup?

By Troy Anderson

David Mahmood has lived through six economic downturns during his seven decades of life.

But the chairman and founder of Dallas-based Allegiance Capital Corp. says he's never seen a financial meltdown quite like the one now.

"I'm seeing the excesses of Wall Street running the economy off the cliff," says Mahmood, 70. "It's really unfortunate. There are too many smart people involved to do what they've done. The packaging, slicing and dicing of these mortgages, along with the failures of the rating agencies, is really borderline criminal. It's a true example of shooting yourself in the foot." ⇨

Even as Congress approved a $700 billion financial rescue package and the Federal Reserve cut interest rates, Mahmood is encountering major obstacles in the financial deals that his investment banking firm is handling.

In one case, an Asian multinational firm was in the process of buying a Texas oilfield services company when a Wall Street firm pulled its $150 million line of credit, killing the transaction. Another Texas company that supplies oil companies with drilling pipe is having problems purchasing enough product from foreign manufacturers because of the banking and credit crisis.

"There are a lot of businessmen out there who don't know what is going to happen," Mahmood says. "They don't know what the banks are going to do, and it's causing everything to slow down to a glacial pace that impacts and impairs people's ability to make solid business decisions. They just don't know if the money will be available, or in some instances, if the bank will even be around."

David Mahmood

As the economy sinks into what many economists say is the worst financial downturn since the Great Depression, the Texas economy has remained remarkably resilient . . . financial downturn since the Great Depression, the Texas economy has remained remarkably resilient, a national rarity. In the last year, Texas has added more than 252,000 jobs, according to the Texas Workforce Commission.

But the credit crisis, ignited primarily by bad housing debt, doesn't know national and state boundaries. As stocks have slumped in one of the worst bear markets since the late 1930s, economists worry that the Bush administration's intervention won't be enough to stave off a potentially severe global recession. Texas representatives are concerned that the financial downturn may eventually drag the Lone Star state's economy down, too.

"I think we're in a very serious crisis," says U.S. Representative Kevin Brady (R-The Woodlands). "We're in good shape today, but if the country slides into recession, if home foreclosures continue to rise and business and consumer credit dry up, we'll take a hit just like every other state."

Brady, who voted for President Bush's Emergency Economic Stabilization Act, says he believes the bailout of banks and other financial institutions will help stabilize the economy, ease the credit crisis, and help businesses get loans – the lifeblood of the American economy.

The act, approved by Congress and signed by President Bush in early October, authorizes Treasury Secretary Henry Paulson to buy up to $250 billion in troubled housing-related debt from banks that have become reluctant to lend money. To access the remainder of the money, the bank president must certify the need. On the final $350 billion, Congress has the option to deny the request. As part of the package, Paulson is also considering taking ownership stakes in many U.S. banks.

The act raises the cap on bank deposits insured by the Federal Deposit Insurance Corporation from $100,000 to $250,000, and lifts the alternative minimum tax on about 26 million taxpayers. It also extends research and experimentation tax credits to businesses and provides tax incentives for investments in wind, solar, and other renewable energy sources.

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President Bush believes much of the investment will be paid back over time. Overseen by a bipartisan panel, the government can sell or hold the acquired assets.

Shortly after the bailout, U.S. Senator John McCain proposed the American Homeownership Resurgence Plan to help families avoid foreclosure and stabilize the housing market. Under this plan, the government would purchase mortgages directly from homeowners, replacing the loans with cheaper, fixed-rate mortgages.

"Millions of Americans on Main Street are feeling the effects of our current economic crisis largely brought on by corruption and greed at Fannie Mae, Freddie Mac, and Wall Street," McCain says. "Our next president must come into office with a plan to address the very root of the failing housing market."

McCain's proposal came as the U.S. Department of Labor announced that the nation's unemployment rate rose to 6.1 percent. For the ninth month in a row, employers cut jobs – 159,000 in September alone – putting the nation on track to eliminate a million jobs in 2008.

Meanwhile, consumers, who account for more than two-thirds of the nation's economic activity, continued to cut back on spending. Manufacturers are seeing business dry up. And new factory orders dropped four percent in August, the biggest decline in two years, according to the Commerce Department.

Protesters at the Fannie Mae building in Washington, D.C. on October 29, 2008, are at the front door demanding to meet with CEO Herbert Allison to ask for leniency instead of foreclosure on peoples' homes. Unethical lending practices have plagued the institution recently.

U.S. Representative Jeb Hensarling (R-Dallas), says he's unsure how effective the bailout will be and is worried about the record federal debt, now exceeding $11 trillion.

"Treasury could spend $700 billion in no time flat and come right back to Congress for $700 billion more," says Hensarling. "Some believe the taxpayer will actually make money in the deal, and I hope that proves true. But with history as a guide, I have strong fears it will not." At the conservative Heritage Foundation in Washington, D.C., economist William Beach says the bailout of mortgage-backed securities is badly

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needed to shore up the financial system. Beach gives it a 50-50 chance of preventing a more serious economic free fall.

"The economy most certainly is in recession now, and the failure of Congress to act would only have made the recession worse," Beach says. "However, I don't believe our global economy will have a long, protracted depression like we had in the 1930s."

Steven Craig, a professor economics at the University of Houston, says he and his colleagues wonder whether the bailout was necessary. And he's concerned about the long-term impact the bailout will have on the risk and reward system that has contributed to the American economy's past success. "One reason the U.S. economy has been on top of the world is because we're willing to take risks and find new ways to do things," Craig says. "And so if every time you take a risk, the feds bail you out, then there is no reward for taking the risk, and resources in the economy won't be allocated as well as they otherwise would have.

"The bailout may make us more like Europe, where statism is a famous part of their economy, which is much lower than ours. So we might be picking a permanent, lower path than we're used to."

Before the bailout, the nation witnessed the shocking collapse of one financial giant after another. A series of banks and financial institutions, burdened by rising amounts of bad housing debt, failed.

In early September, Lehman Brothers Holdings Inc., the nation's fourth-largest investment bank, filed for bankruptcy. That same month, federal regulators seized Washington Mutual Bank and sold it to JPMorgan Chase & Co; Bank of America purchased Merrill Lynch Co. Inc.; Wells Fargo & Co. will acquire Wachovia Corp. And Goldman Sachs and Morgan Stanley will convert into commercial banks. This catastrophic chain of events was preceded by federal bailouts of mortgage-finance giants Fannie Mae and Freddie Mac, as well as the American International Group.

With many banks and financial institutions teetering on the brink, Beach expects more to fail in the months ahead.

"Many are insolvent now," Beach says. "And there is no way the government can make them solvent again. The best the government can do is to make sure the banks that are teetering on the edge of insolvency remain solvent, by taking off their books these non-performing mortgage-backed securities that currently have no value whatsoever."

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As rates on teaser loans adjusted, many borrowers were unable to pay their mortgages and lost their homes.

Since 2007, the nation has experienced more than 900,000 foreclosures. And more than 2 million mortgages are delinquent 60 days or more.

Democrats blame much of the crisis on greedy Wall Street executives and lax regulatory oversight by the Bush administration. Republicans argue that Democrats blocked reforms of Fannie Mae and Freddie Mac that could have prevented the crisis.

But at the root of the housing bubble, some economists contend, are U.S. policies encouraging home ownership through home interest deductions and an implicit promise to intervene if Fannie Mae and Freddie Mac had problems.

Most economists agree that deregulation of the mortgage industry made it possible for banks and other financial institutions to give loans to people who couldn't afford them. And by the time housing prices plunged and foreclosures mounted, many of these lenders had already sold the mortgages to investors as mortgage-backed securities.

In the decades prior to 2007, the U.S housing market had "done nothing but go up," says Andrew Lo, a professor of finance at the Massachusetts Institute of Technology's Sloan School of Management.

"The housing boom made homeowners, investors, mortgage brokers, and other lenders complacent about the underlying risks inherent in these complex securities," Lo says. "The fact the housing market never had a significant decline over a 30- or 40-year period, up until 2007, allowed us to think there would never be a decline. It really caused more risk to be taken than should have been, and the entire country really got caught up in that."

Stan J. Liebowitz, a professor of economics at the University of Texas at Dallas and a research fellow at the nonpartisan Independent Institute, argues in a recent report that various branches of government begin attacking underwriting standards in the 1990s in an attempt to increase home ownership, particularly among minorities and the less affluent.

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"This weakening of underwriting standards succeeded in increasing home ownership and also the price of housing, helping to lead to a housing price bubble," Liebowitz wrote in the report "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown." "The price bubble, along with relaxed lending standards, allowed speculators to purchase homes without putting their own money at risk."

Instead of a "subprime mortgage meltdown," Liebowitz argues that the main drivers behind the foreclosures are adjustable-rate mortgages, both prime and subprime. These mortgages, requiring very low or no down payments and no income verification, are the main source of the financial meltdown. Lenders promoted these "innovative" loans ceaselessly, but not without a big push from the federal government, Liebowitz argues. At the behest of Congress, Fannie Mae and Freddie Mac conducted a profitable but risky scheme to promote increased homeownership.

Another complicating factor behind the mess is the highly complex nature of the assets traded in the financial sector – the infamous mortgage-backed securities, derivatives, and credit default swaps. The near-collapse of AIG revealed how trades involving these financial instruments could spread throughout the financial world, putting other companies at risk, too.

Kumar Venkataraman

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Kumar Venkataraman, an associate professor of finance at the Cox School of Business at Southern Methodist University in Dallas, says the creation of these instruments during the early part of the decade is a major factor behind the banking industries' woes.

"They started doing financial engineering where they were slicing and dicing these securities and creating more complex securities that were all based on the validity of the homeowner to keep paying off their mortgage," Venkataraman says.

As home prices dropped, mortgages adjusted higher, people lost their jobs, debts mounted, and many found they could no longer afford the American Dream, defaulting on their mortgages.

"Stocks plummeted today on forecasts that the sun will rise again and tomorrow will be another day."

But Texas has been spared the worst of this meltdown, which is most pronounced in states like California, Florida, and Nevada. Across the nation, home prices more than doubled from 2000 to 2006. However, home values in Texas rose more modestly during that time. For instance, the Dallas area saw an increase of about 30 percent, according to the S&P/Case-Shiller Home Price Index. As a result, the mortgage meltdown affecting the rest of the nation hasn't hit Texas as hard.

"It's absolutely unique how Texas has managed to expand in this economy," says Ed Friedman, a senior economist at Moody's Economy.com. "It's very unusual. It's 49 to one. But Texas doesn't exist in a vacuum. Their expansion will slow and probably stop for awhile, but you won't see an outright decline. So, Texas will do relatively better, but it will certainly feel this recession in the rest of the economy."

Due to its continuing population growth, oil industry, expansion in military spending, large amount of trade, and corporate relocations, Friedman expects Texas to do better economically than other states. But he says it will experience a slowdown in non-essential product sales, and employment growth will level off.

"You put this all together, you have a state with a huge number of relatively good drivers," Friedman says. "It's like if you were playing cards in Texas, they have all the aces."

For some Texas investors, the economic downturn provides a rare opportunity to buy distressed companies, properties, and mortgage-backed securities while prices are low.

"We are seeing more opportunities and don't see this as a bad thing, but like any investor in this business, you have to be sensitive to buying that proverbial falling knife," says Phil Dixon, president of Treadstone Partners LLC, a Dallas investment firm. "You may have a good opportunity, but you don't want to buy it on the way down."

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Willliam Beach

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Another opportunity in Texas involves investing in new energy sources, says Lothar Katz, president of Leadership Crossroads, an international business consultancy in Dallas.

"It doesn't take a crystal ball to figure out that investing in alternative energies is one of the safest investments, and that is an area where Texas is among the leaders in the U.S. with wind and solar energy," Katz says.

As part of the solution to the current economic crisis, Katz says the next president needs to boost confidence levels, find a middle ground with past policies that seem to have benefited a small segment of the population the most, and develop a clear strategy for energy independence.

"There is a strong wind energy industry in Texas and there are some solar energy investments, but they are really not at a scale that seriously makes them a promising alternative to oil," Katz says.

At the Merrill Lynch office in Houston, Vice President Rick Figueroa says the Texas economy is strong, but it's not an island. Before the economy slows in Texas, Figueroa recommends that business owners and chief executive officers plan how to weather the crisis. He suggests that businesses talk with a certified public accountant about writing off losses and saving on tax liabilities.

And when seeking loans, Figueroa says business owners and CEOs should bear in mind that bankers want to know if a business will be able to pay off its loans. He encourages business owners to fix any errors on credit reports and consult with several banks. Figueroa says that banks have different portfolios of loans and like to be diversified.

And while economic storms can be trying times for businesses, Figueroa points out that downturns also provide opportunities.

"The bottom line is, when a storm happens, focus is such a big key," Figueroa says. "When I give advice to anybody, whether it's a business owner or Joe investor, it's to be focused, be disciplined and asset-allocated, and not let the economic environment change you. A lot of people have a tendency to let headlines change their investment and business strategies, when they should always be disciplined and asset-allocated. That is how wealth is created." N

Troy Anderson is an award-winning newspaper reporter based out of Southern California who also freelances for a variety of national and regional magazines.