

American Enterprise Institute

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[Edited transcript from audio tapes]

2:15 p.m. Registration

2:30        *Introduction:* [Alex J. Pollock](#), AEI

2:40        *Panelists:*     Tim Bitsberger, Bitsberger Consulting  
                         Barry L. Ritholtz, Fusion IQ  
                         Joshua Rosner, Graham Fisher & Co.  
                         Walker Todd, American Institute for Economic Research  
                         R. Christopher Whalen, Institutional Risk Analytics

*Moderator:*   Alex J. Pollock, AEI

4:30        Adjournment

Proceedings:

Alex J. Pollock: Good afternoon, ladies and gentlemen. I'm delighted to have you all here and welcome to our conference on "Bust, Bankruptcy, Bailouts and What Should We Do Now." This conference is jointly sponsored by AEI and the Professional Risk Managers International Association. And thanks to Chris Whalen, my partner who represents the professional risk managers and as the co-organizer of the conference.

One needs hardly to comment, the sequence that we have been experiencing from bubble to bust, to bankruptcy to bailouts, and so, what next? Well, by way of context, I just want to say a few things. Karen, if we can have our first slide up here. Here is a picture of the housing bubble as represented by the Case-Shiller National House Price Index which they publish quarterly. The obvious bubble-like inflation of the prices from the trend is clear. The last real point down there is the third quarter point. The red line is just an extrapolation of the trend of the last century up to 2000. And if you just said how long it would take you to get from the peak to that extrapolation, it is 28-percent decline on average house prices from the peak, so call it 30-percent to get to the trend.

Now I know that some of my colleagues on the panel think there is further in house price falls to go than another seven or eight percent. By this chart, I do not mean to convey the

idea that I believe that things stop when they get to their trend line, which they do not necessarily do, but this is just a notion of how far you would have to get, more or less, 30-percent fall from the peak to get back to the trend in average house prices for the country. That is a huge asset deflation.

Well, speaking of asset deflations, we can look at the next slide. We all know about this but I wonder if we have just gathered these numbers to mind. These are the changes in stock prices from the peak of the financial services index in May 2007 to yesterday. These are really, when you stop to think about it, some boggling asset deflation numbers. I'll just read you the list quickly: Citigroup, minus 94 percent; AIG, minus 98 percent; Bank of America, minus 87; JPMorgan Chase, minus 52 percent; Morgan Stanley, minus 73 percent; Goldman Sachs, minus 66 percent; American Express, minus 74 percent; Prudential, minus 73 percent; Hartford, minus 86 percent; MetLife, minus 59 percent; SunTrust, minus 85 percent; Capital One, minus 78 percent; Allstate, minus 56 percent; Fannie Mae, minus 99 percent; and Freddie Mac, minus 99 percent. But also, the equity market has delivered its own deflation. They are even more striking than the housing market. So we are looking at this slide. A couple of other things, the FDIC budget for 2009 includes 832 new positions open for receivership and liquidation functions - a good sign of the times.

And, finally, I have a nice quote which summarizes the situation. Actually it is my penultimate point, quite finally. This article says, "The future of the nation's financial system has flashed into view. We have had the biggest bank merger in history, the biggest insurance bailout ever, the largest failure of a bank or thrift. Get used to big-name financial institutions disappearing. The U.S. financial services industry is entering an era of wrenching change," Washington Post, July 22, 1991. These things are cyclical as some of you have heard me say before.

My final point is to recall a recommendation of a former chairman of what was then Chase Manhattan Bank, George Champion who was chairman in the 1960s. His advice to banks was to "Increase your loan loss reserve to five percent of loans or more because banking is so uncertain a business." Well, we did not do that and so here we are. And we can go back to our title now, Karen, up here.

So not having built up sufficient reserves, to say the least, and we have had bailouts, what have the effects of the bailouts been? Have the bailouts been successful? What are the best ways to understand where we are now? And thinking about going forward, what should be done now? What should not be done?

Our distinguished panel will address these questions and doubtless, some others, and they will be speaking in alphabetical order. We will hear first from Tim Bitsberger, down on the other end here, of Bitsberger Consulting. Tim was previously the senior vice president and treasurer at Freddie Mac, responsible for the company's debt and mortgage funding programs, so he has been at the center of this crisis. Before that, he was the assistant secretary for Financial Markets at the Treasury Department, deputy assistant

secretary for Federal Finance at the Treasury and worked in Wall Street for 15 years and he is also a director of the CME Group.

Next will be Barry Ritholtz, who is the chief executive and director of Equity Research at Fusion IQ, a quantitative research firm. He is the author of “The Big Picture,” a financial blog and a regular guest on Kudlow & Company, Power Lunch, Fast Money,” Bloomberg, Fox and PBS with market perspectives that are regularly quoted. He has a forthcoming book, Bailout Nation. He is a director of burst.com and teaches at New York University School of Continuing and Professional Studies.

Third will be Josh Rosner who is a managing director at the independent research consulting firm, Graham Fisher & Company, where he advises on housing and mortgage finance issues. Previously he was with Medley Global Advisors working on policy issues: monetary, fiscal, regulatory and political. He was very early in identifying the problems of the current bust with the government-sponsored enterprises Fannie Mae and Freddie Mac, the peak in the housing market, the likelihood of illiquidity contagion in credit markets and the weaknesses of the credit rating agencies, and has co-authored papers dealing with all of the above.

Next will be Walker Todd who is a research fellow for the American Institute for Economic Research, where he has worked since 1995. He also teaches the history and origins of competing theories of property rights, has 20 years experience at the Federal Reserve Banks of New York and Cleveland and is a director of the Committee for Monetary Research and Education. He has numerous publications on banking and central banking, monetary policy, property rights, international debt, and financial regulation.

Concluding the panel will be Chris Whalen, who is the co-founder and managing director of Institutional Risk Analytics, who worked previously as an investment banker, research analyst and journalist for more than two decades. Chris contributes to publications such as Barron’s, The International Economy, and American Banker, and he does represent here the Professional Risk Managers International Association of which he is the regional director of the Washington, D.C. Chapter. And Chris, thank you again for cosponsoring this with us.

We will give each panelist 12 to 15 minutes to discuss these exceptionally challenging issues. We will then give them a chance to respond to each other and after that, we will open the floor to your questions and we will adjourn promptly at 4:30 or whenever your questions run out, whichever is first. And now turning to our exceptional panel on these exceptionally difficult issues, we will start with Tim.

Timothy S. Bitsberger: Thank you, Alex and thanks Chris. Alex, your quote from The Washington Post is the perfect segue for my remarks, and I'll begin. Mark Twain said history may not repeat itself but it certainly rhymes. Benjamin Franklin is alleged to have said that the definition of insanity is doing the same thing over and over and expecting it to come out different.

You know there are reasons why history is a required subject, or at least it was a required subject in schools that I attended. Every year, a craft carrier landing made by a Navy pilot is graded and recorded. A log is kept to monitor its progress. Before any problem - and I think this is the heart of the matter that we face right now - can be solved we must fully understand what has happened.

I say all this because what is most apparent in anything we do, particularly those experiences that have gone wrong or bust, is that we can only find solutions until we can dispassionately fully debrief and understand what transpired and what the consequences were, both intentional and unintentional. I do not think we have done this yet. The only thing that I know is I do not know what exists on bank balance sheets, to some degree the GSE balance sheets and other financial institutions. The reason why it is so hard to come up with a solution today is because we do not fully comprehend the types of securities these firms own, how they have been structured and where they exist on the balance sheet. And until we can fully grasp that, I think it is very difficult to come up with the right solution.

I do not know about the rest of the panelists here but I have kind of rewritten my comments numerous times, particularly over the past couple of days as events have unfolded. What I wish I could do is present a slide-by-slide comparison of all the bailout packages currently under consideration. I believe unintended consequences of borrowing have gotten us into this mess. We were talking earlier at lunch today that a lot of that has to do with the credit explosion that was just when unencumbered and unregulated, and I just do not want to make the same mistake twice. Growing balance sheets, whether it is at the municipal, corporate, bank, individual or national level, I think, are things that need to be considered very, very carefully. This afternoon I want to focus on three themes: What the problems generally are, what the current environment looks like and what the solution should look like.

So what are the problems that the Treasury, the Fed, the FDIC and market participants are trying to solve? I do not think you would find consensus on how to rank those problems, much less agreement on those problems within those agencies or within the banking industry. The FDIC-guaranteed debt program, for example, has caused confusion to GSE debt market. When the FDIC launched its guaranteed debt program in September, October of the past year; that caused a widening of GSE debt to swaps as well as to Treasury's. Again, that was an unintended consequence of the FDIC trying to act in the best interest of its banks.

I applaud the fact that the new administration is vowing to dump the disastrous ad hoc approach adopted by the last Treasury group. But before we get their comprehensive solution, it will be helpful to understand the reason and understanding for what the problems are and why.

Let's take a look at the other field, the housing and mortgage market. Is the problem delinquencies? Is the problem inventory levels? Is it the level of mortgage rates? Is it the level of securitizations and subsequent trading volumes or is it home prices? Sure,

some of these are related but I would argue that some of these are problems requiring different fixes that could exacerbate some of the other problems. What about the credit markets? Is the problem liquidity? Is it excessive leverage? Is it poor regulation? Is it accounting evaluation? What about the broader financial markets? Is it a problem of solvency, liquidity, both?

Sometime, particularly since Bear last March, I believe policymakers did not understand the relationship and differences of a lack of liquidity and a lack of solvency. The two are related but very different. For example, a private equity firm with little or no leverage should not care about the liquidity of its investments. It is a long-term holder. But a thinly capitalized trading firm could be forced out of business if haircuts are raised on the collateralized positions as was the case with Carlisle Capital, I believe, in the fall of 2007.

Liquid markets do not necessarily improve solvency; they can even mask it. I believe the largest problem today we face is solvency. We are sitting on piles and piles of debt, much of which needs to be restructured because the cash flows the assets generate cannot support the corresponding debt service. So whether the restructuring is good bank/bad bank, guarantees or FDIC like nationalization or restructuring, the core problem will not be addressed until this is solved. But more on that later. I do however applaud the Fed for maintaining liquidity in several key markets.

To me, there is a couple of basic problems, and in no particular order and they all happen to begin with the letter D, it is debt, deleveraging, deflation and the big question mark, are we in a depression?

Deleveraging needs to occur and debt needs to be restructured. Granted some deleveraging has occurred in the primary dealers, banks, trading firms and hedge funds, but other levels of debt are not falling much, including at the national, municipal and individual level. The levels of debt in this country are constant or rising but the value of the assets they are supporting are falling. The Fed is picking up the pieces. Treasury will be looking to pick up the pieces. I think the question that they need to resolve as a group and they need to articulate this very cleanly is, how much do they replace? What is the role of government in this smoothing out process? How much downsizing do we need?

Delinquencies have yet to be fully addressed. Should the principal be written or crammed down? I do not know. But talk about moral hazard. In general, I would say that there are three groups of people that are in the mortgage market. There are some that should never have to have a mortgage. This first group, I think that there is no safety net. We, as a country, do not have a safety net to save this group. And unfortunately, I think they should be renters and not owners and to face the consequences.

The second group will be the ones that were maybe adversely selected by predatory lending, people that got kind of talked into ARMs that were going to cut somewhere in the middle to be able to afford one certain interest rate and not another.

And there is a third group that is largely unaffected that knew what they were doing and can afford the mortgage they are in. I think that any delinquency efforts to target that middle group, the ones that either face predatory lending or the ones that do not fully understand the resets that their mortgages encompassed.

Next, deflation. I view this as a crisis of confidence issue. I think it is very short-term in nature, but I think this might be the big reason why able borrowers do not want credit. When you are in a flat-to-negative pricing environment, why borrow money if the value of that asset could fall in the future? Again, I view this more as a loss of confidence than in any real kind of structural trend that we are going through.

Most importantly, I think something that we tend to forget is this is a global problem. In fact when you compare the United States to the U.K., to Ireland, Spain, Portugal and Greece, all countries that have been in the headlines the last three or four days, the U.S. looks in comparatively great shape. The net result of all these is that the banks do not have the capital to extend credit and there is a smaller and smaller number of credit-worthy individuals and entities that they economically should lend to.

And lastly, the big question mark, are we in a depression? You know, I'll defer to other people in the audience or on the panel but I do not think that there is an economic definition for the word "depression." However, what I lean on is that at falling asset prices and constant or rising debt levels, it sounds like a pretty good one to me.

A couple of comments on the current environment. We had huge trade balances, we had large budget deficits, and we had a bubble in housing. We had a bubble in credit. I think we all recognize that this was occurring and some panelists here recognized it very early on. We all recognized all this and we were trying to move to the right place. If we were and are moving into long-term equilibrium, how can government policy today help smooth out that transition? How can government intervention today help smooth that process? That is to me the unanswerable questions, at least, from where I sit.

We all know the headline data but there are some facts that interest me. There is a continued lack of confidence. Corporate bond spreads, although they have come in about a hundred basis points are sold by 400 basis points above their mean. The spread between corporates and mortgages are close to an all-time wide. There has been some recovery in credit but only from levels that we have never seen before. In the same way that risk premium was placed out of the market in 2006, the pendulum has swung just as far in the other direction, meaning that some credit could be trading below its economic value.

Treasury borrowing could triple or quadruple this year. That is just for someone that has spent a long career at trading treasuries and other types of securities including mortgages, for someone who is in charge of the debt funding program at Treasury, that is as an unfathomable concept to me. The Treasury borrowing is going to explode in the face of dealer balance sheets shrinking, dealers going away, dealers getting merged, in the light

of trading volumes they are decreasing, trading volumes are probably at the level they were now in 2002 or 2003 after explosive growth earlier, in the mid-part of this decade.

And probably, most importantly, the growth in foreign central bank reserves is slowing down dramatically. In the past year, the growth of foreign bank reserves was larger than the U.S. deficit. For example, when the U.S. deficit was about \$400 billion, I think the growth in foreign bank reserves that year was about \$500 or \$600 billion so it was enough to totally swallow the deficit in this country. That situation has changed dramatically. Estimates for foreign bank reserves in 2009 are somewhat less than \$200 billion. This could have a huge implication for the level and term structure of interest rates.

Sovereign debt worldwide is being downgraded - Spain, Portugal, Ireland, all of them downgraded and Greece is on watch. Germany recently downsized an auction by 25 percent so it would not fail. Singapore is considering drawing down on its reserves to pay for a stimulus package. As a worrisome sign, many of the largest foreign reserve managers looked to Singapore as best in class in reserve management. This could have a cascading effect on sovereign borrowing costs worldwide and how sovereign debt managers view their reserves.

According to a recently published Fed paper, borrowers are now more dependent upon the capital markets as the largest supplier of credit versus banks. The banks no longer own that top slot. This is a result of the increase in securitizations over the past six to seven years. Maybe this is why the Fed is targeting GSC paper which is the largest securitized market. One quick digression: I hope the Fed is buying GSC and MBS to support credit through securitization and is not trying to manipulate rates, at least not yet.

Housing prices are getting a lot of attention, and Alex alluded to a seven percent number. But prices may need to fall further. And if policymakers, financial institutions and home owners are dependent upon house prices stabilizing, then we are in for just an incredibly ugly situation if housing prices continue to deteriorate. If you look at the Case-Shiller data, we are back to about 2003 price levels. If we would to get back to something in the mid- to late '90s, that would argue further 20 to 35 percent downsizing in house prices. So again, if policy is based upon house prices stabilizing, that, to me, is just a worry that I would have in the back of my mind.

There have been some excellent policy responses recently. I think several of the Fed programs have been very successful, including the swap lines with other central banks, though there is credit risk. The lending of the SOMA account has worked very well and the money market program has worked well. These I would view as lifesavers and they were very much needed at the time.

I also think and hope that the Fed is being forced to purchase agency debt in MBS because banks are hoarding cash and banks' excess reserves at the Fed have risen dramatically. This is the main driver why the Fed balance sheet has grown from \$800 billion to about \$2.2 trillion. One could argue that the Fed has pushed the envelope as the

lender of last resort, but in an environment where dealers cannot obtain capital and leverage ratios are under pressure, in an environment where traditional credit buyers are walking away, they may have no choice but to buy these securitized products. I agree with Chairman Bernanke that the Fed has not begun technically quantitative easing yet because of the excess reserve growth but they are entering uncharted territory nonetheless.

What has not worked? Well, TARP. I do not think any more needs to be said on TARP. FDIC guarantee - the FDIC guarantee program, I think to create an environment where all credit is created equal and where price discovery in the marketplace no longer exists, I think is a very dangerous precedent. I touched on it and how it is affecting the mortgage-backed security market, the GSC market, and I view that as an ad hoc approach by the FDIC, not really done in concert maybe with other programs that could not exist.

However, I think the biggest failing, and this occurred at the Treasury Department, has been the ability to communicate to the marketplace. You know, Alex touched on my background a couple of years at Freddie Mac, a couple of years at the Treasury Department, but the bulk of my career has been spent on the trading floor trading all these securities I have just been talking about. And I would like to say bond traders are paid to be paranoid. If you do not know something or if you get some kind of opaque answer, you are just going to hit the next bid and walk away until you have the certainty. And I think the lack of articulate communication from Treasury to the marketplace has been a major cause of this.

I do think solutions should adhere to certain ideals - and I'm almost done, Alex. It should target a defined set of problems and articulate its goals. It should provide a means for monitoring. It should provide articulate messages and some type of scorecard. It should have an exit strategy. But most important, it needs to be implementable. I worry that many of these solutions we are talking about are not implementable.

In terms of specifics, there is no silver bullet. There is no foolproof solution. However, if I were to start with the one place, I would start with the banks. They need to be restructured, they need more capital, some will need to fail. The so-called toxic assets need to be removed. I do not know if the answer is guarantees, if it is good bank/bad bank, if it is nationalization/restructuring/sale, all of the FDIC. As The Washington Post reported, none are perfect and all have flaws.

I do think the best approach would be to nationalize the banks, meaning all equity holders and credit holders would either be wiped out or earn some cents on their dollar. These restructured banks could be auctioned off, it is almost similar to the FDIC approach in the 1980s, but I worry that this is completely infeasible, and implementation would fail to the political pressures and government incompetence.

I'm not sure that good bank/bad bank is the right approach but it may be the cleanest, at least from the bank's point of view. It will need to be aggressively managed. It will

allow the banks to regain the confidence in investors. But I do not know at what cost. Giving the government equity at these share prices will, in essence, nationalize the banks.

I cannot believe I'm about to say this but one alternative could be for the taxpayer just to foot the bill. That is clean, but I do not like it. There maybe another cost and I would like to think that maybe the whole idea of fair value accounting, I understand we cannot abandon it completely but I think that needs some discussion. Right now, fair value accounting is liquidation accounting and it is liquidation accounting building on a huge risk premium. I do not think that was the full intent of fair value accounting.

Another problem with the bad bank idea is determining the process for price discovery. The problem with a reverse auction is that all the assets look so different. It is challenging to make a relative valuation particularly on such a large scale.

In terms of the guarantee options, taking market pricing out of the equation, I think, is disastrous. All credit is not created equal.

I have a couple of other comments maybe I can get to later but I'll close, Alex, by saying, if the time comes and the Fed needs to think long and hard about monetizing debt and introducing real quantitative easing, I worry about the long-term effects on our currency. John Maynard Keynes liked to quote Lenin and say, "The best way to destroy the capitalist system was to debauch the currency." Thank you.

Alex J. Pollock: Thanks, Tim. Barry?

Barry L. Ritholtz: All right, the difficulty here is trying to get 90 minutes worth of material into 12 minutes, so I'll do my best and try not to speak too fast.

Timothy S. Bitsberger: Sorry.

Barry L. Ritholtz: Thank you, Chris. I'm much worse than you and it is a conscious battle to keep it to an understandable pace. Thank you, Alex. Thank you, Chris.

I'll begin with a quote also and I'm going to go to Benjamin Disraeli who pointed out, "The one thing we learned from history is that we learn nothing from history." And that happens to be as true in this instance with housing, with credit, with nationalizing banks as anything else. I want to put us into context of how we got here so we can understand where we are going and what our options are. And I'm going to give you a very, very brief history of finance.

For the past 14 million years, all of credit and finance was based on one simple element, and that is the borrowers' ability to service the debt. Now I know this may sound a little radical to some people but the ability for a borrower to pay that money back, be it credit card, mortgage, what have you, is key. And if you look at a continuum, it is from about 14 million years ago when Og the Caveman wanted to buy that newfangled wheel, so he borrowed 14 clams from the guy next to him and the next caveman said, "Well, Og is a

good hunter and he is a good provider. He can pay that back.” And that was the first commercial credit transaction.

From 14 million years ago until 2009, that was the basis for lending, with the brief exception of 2002 to 2007, when the basis for lending was no longer the debtor’s ability to service the debt, instead it was the lender’s ability to take that debt and sell it off to someone who is going to securitize it. That is a sea change; that is a universe change that impacts everything. It impacted how creditworthy the borrower had to be; it impacted what ultimately happened with that debt; and of course, it impacted how it defaulted down the road.

I’m going to skip over a lot and just skip to one fascinating little point - the traditional method, the borrower’s ability to service the debt, crazy though that sounds. In the old days, if you were a small bank in a town, you would know somebody who would come to you for a mortgage and you would see them at Little League games, in the supermarket, and your bet was, can this guy, based on how much money he is putting down, what his other credit obligations are, the value of the house, the loan to value, et cetera, et cetera, is he a good bet for 30 years? And that would color the lender’s perspective. Is this person going to pay this back?

When we shifted to a lend-to-securitize model, that 30-year number went away and it was replaced by a different number and that number was the warranty, the originator, mostly non-thrifts, primarily located in Southern California. What sort of warranty they gave to Bear Stearns, Goldman Sachs, Merrill Lynch, Lehman Brothers that this would be good for - that it would be current; it would not default. Anyone know what that number is? Anyone can take a guess how many years that number was?

Male Voice: Ninety days.

Barry L. Ritholtz: Ninety days, that is exactly right. That always horrifies people when they hear that. There were actually a swath that was six months or 180 days but they were really the exception. So when you are lending for 90 days as opposed to 30 years, your standards tend to drop a little bit. And then to make matters even more intriguing, instead of doing 30-year fixed, what is a more surefire way to make sure a loan will not default in three months than to do a 228? A low teaser rate for the first couple of months, 24 months, and then it pops up to a different rate. Of course, you will be able to refinance at the time because your house will have appreciated so much, because remember, home prices never go down.

So that is a brief history of financing and the securitize-to-lend and that is more or less how we ended up in our current situation. If you want to get a sense of exactly the repercussions of that, home prices are now down according to Case-Shiller by 25 percent. I'm not a big believer in what used to be the OFHEO Index which backs out distressed properties, foreclosures, anything that they did not like. You know, in college I played baseball, and I was a 700-hitter, X strikeouts. So if you want to go X foreclosures you end up with a number that does not really give you an accurate read on

it. And according to OFHEO, home prices are just fine; they are kind of plateauing if they are rising nicely and it is an absurd number. But that leads us to a question - where are home prices going to go? Where should we allow them to go and are there any virtues to foreclosure? And I actually think there are virtues to foreclosure.

When you look at the total home sales for the past 20, 30 years, in the '90s there were three, three and a half million a year. By the time we got to the early 2000s, we were doing three-and-a-half, four, four unchanged and then during that boom period when credit was readily available - and by the way, my favorite story was there were two great pickers in California making \$15,000 a year that got a \$750,000 mortgage - that was actually reported. I do not know if they are still current but I would imagine they are not. And when you look at the subsequent reactions of what happens, you end up with, "We are down 25 percent." Any historical metric of home prices - my favorite is median income to median price; you could look at the approximate cost of renting versus owning, you could look at the relative inventory that is out there - we are still significantly elevated from historical means, not three standard deviations the way we were two-and-a-half years ago but we are still a good ways away and we could get back to that mean in two simple ways.

One way is that we just go sideways for the next seven years and let whatever inflation is out there do its thing, or we could see a 15- to 25-percent drop tomorrow and that would bring us back. Of course, that does not answer the question, why do we think we are going to go back to the mean? Historically, you tend to careen way past it and go to deeply, deeply oversold levels. If you look at the Nasdaq in 2003, there were a number of profitable debt-free tech companies that were trading not for less than book value, less than cash on hand - \$0.75 versus a dollar of cash on hand - which just shows you how efficient and rational the markets can be when things get a little out of whack.

But we are in the process of seeing prices revert to where they should be. You will know they are at a decent level when a newlywed couple in your hometown, wherever it may be, outside of New York or D.C. can afford to buy that starter home because the way real estate works is it is a process of move-ups. The starter home seller buys the upgrade, who buys the bigger house, who buys the beach house, who buys the 14-bedroom mansion on 5th Avenue, but it is a process and real estate is essentially stuck in the mud until the starter homes can be sold. So if a newlywed couple can afford the cheapest house on the ugliest part of town, you know you have problems and that is where we are now.

Look at the most recent data that just came out. The existing home sales for December, everybody was lauding, wow, we saw a six-and-a-half percent increase from November, down three-and-a-half percent from the year before. And put aside the fact that that number, every month the National Association of Realtors revises their numbers downwards; they have been doing these for two years, three years, so the December numbers are going to be revised lower. But if you actually look beneath the headline, there was a fascinating statistic and of all those existing home sales in December, 45 percent of them were either foreclosures or distressed. So that means that about half of

the houses would not have been sold without a very, very significant haircut in price. And whenever anybody says or tells me they are having a hard time selling their house, I say it is simple - you could sell any house in America, just cut its price in half and it is sold. And I think that is the process that we are working away through. You are not going to see an economic recovery, you are not going to see a housing recovery until home prices get to the point where it is a self-sustaining cycle and a chain of purchases.

Back to those numbers - three million in the early '90s, four million in the early 2000s. From 2002 to 2007 we worked our way up to over seven-and-a-half million homes sold in one year with a modest increase in population. That suggests that over that five-year period, we put anywhere from six to nine million people in homes beyond the normal. So far, we have seen two million foreclosures. I'm going to follow Tim's suggestion of three buckets of people and that bottom bucket is likely to be two to three more million foreclosures over the next few years, which actually is a good thing because when you are in a house you cannot afford, staying in it, paying the mortgage, when it is beyond the value of the house makes no rational economic sense. In my office, they are not called homeowners. They are called it home-overs because they owe more than the value of the home so it is silly for them to stay there.

Again, this all goes back to securitizing and lending money with absolutely no standards whatsoever. As we work away through this foreclosure process, it is going to hurt, it will be painful, it will hurt the economy, but it is an absolute necessity. I cringe every time I read someone in Congress wants to rescue the homeowners, and they are people that you can rescue because they can feasibly afford to stay in their home with a little modification. Right now, the banks are dropping rates to five and a quarter and extending the mortgages to 40 years. That is a tiny percentage. That really will not get the job done.

My personal favorite thing they should do is pull out 25 percent or 30 percent of the mortgage and put it in a 10-year balloon payment. You do need a little bit of some legislation so that no longer becomes a tax reloan that they owe income tax on, and the bank needs a little legislation to allow them to put that aside and not write it down for 10 years. There is a better chance that that home stays around and that the mortgage stays current. But you are not talking about those six million people. You are talking about 400, 800, maybe even a million people that would fit for that and qualify. Beyond that, once we get beyond that, I look at the issue of the banks and the bailouts and how much money we are throwing into what essentially has been a black hole.

Let me just digress for a quick second. Add up the total amount of money the U.S. government has spent, either actually laid out, spent via Fed guarantees, guaranteed or taken back on the taxpayer balance sheet, and it is \$14 trillion; \$14 trillion or about one year's GDP of the United States, which is a pretty astonishing number. About two years ago, we had \$15 trillion as a target for the U.S. total GDP by 2011, 2012. And now that is likely pushed back to 2015 to 2016. But put that aside, I think we need to stop thinking about these bailouts in terms of taxpayer-funded and start thinking about the taxpayers as investors.

As investors, it is been a horrific deal for them. We are basically rewarding incompetent management that has demonstrated an inability to handle risk, to handle mergers, to do anything that they are supposed to be doing. Everyone talks about too big to fail. When I look at Bank of America and Citibank, I think they are too big to succeed. No one has been able to manage the risk there. There are too many moving parts.

I'm in favor of nationalizing them across the boards. You actually have a lot of -- you go through triage first, basically find out who is rabid and needs to be put down, and then you identify who could be saved beyond that. If you look at Bank of America, they actually have a lot of great components but for being saddled with hundred of billions of dollars in toxic assets, you know, X the toxic assets, there are 700 hitters. So take Bank of America, you have Bank of America's legitimate entity minus their bad debt; you have Merrill Lynch with, again, back out their bad debt and there is a real entity there country-wide; China Construction Bank and a whole run of other holdings. If we pull out all of their bad assets into whatever you want to call it, an RTC-type resolution situation, a bad bank can settle this side, you could give them a year to spin out 10 percent to the public and five years later the rest of it, and these become publicly-traded companies. And the taxpayer actually gets something for their money that up until now has been thrown into a black hole.

Alex J. Pollock: One minute, Barry, one minute.

Barry L. Ritholtz: Someone asked me, do I think that TARP is successful? And I had said, "Well, I do not really know what the TARP's objective was. Are we buying bad debt? Are we recapitalizing the banks? Are we jumpstarting the economy? Are we saving mortgage holders or homeowners?" And the only answer I could come up with was that TARP's purpose was to spend \$700 billion. So in terms of the first half of it, since we have pissed away \$350 billion we have to say it has been successful. We have spent that money, that was the goal, and that is pretty much where that is.

Beyond what we are looking at going forward, I think ultimately we are going to end up in something that looks like nationalization. I think we have to stop pussyfooting around and calling it for what it is. We could recapitalize. We could spin off the bad debt. The only difference is how badly are you as a taxpayer going to get hurt in what you get for your money. Right now on Citibank - also another one, Travelers, Smith Barney, you can spin out all those separate entities - Citibank, the government owns eight percent; Bank America, they own six percent, yet we have put in a 105 percent of their market cap. That tends to be a really bad deal from an investor standpoint.

So I think we need to stop thinking about this unlimited source of income and revenue that is Uncle Sam and start approaching this as portfolio managers and investors, and say before we drop another trillion or two - and you know, a trillion here, a trillion there and it is real money - we really need to start thinking about what we are going to get back for it. So far, we have gotten very little at great costs. I would like to see that reversed.

Alex J. Pollock: Thank you, Barry. I very much share the view that we ought to look at taxpayers as investors in this deal and ask how to treat them as investors. And when we get to the question period, I would like to take up whether 14 million years ago, they had an adjustable clam loan, okay? Josh.

Joshua Rosner: Well, just a little bit of background on where I came from on this. In the summer of 2001, we had just come out of a short-lived recession. Clients were calling, saying housing typically lags the real economy by 12 to 18 months, is housing going to turn down soon?

I wrote a 25-page paper which I later presented at the American Urban Real Estate and Economics Association saying, "No housing is going to outperform GDP by leaps and bounds for the next several years until such time as unemployment rises, interest rates rise materially or home prices, actually, appreciation falls.

In the third quarter of 2005, I called the alarm saying that we were at the end of the game and, unfortunately, that the problems we were going to be held to pay. Now what was it that drove my analysis in '01? For the first time in 200 years of American history, we reduced down payment requirements from 20 percent to zero, we changed underwriting standards from manual underwriting at your local branch to automated underwriting, we perverted the appraisal process --

Alex J. Pollock: At Fannie and Freddie, excuse me.

Joshua Rosner: No, this was all at Fannie and Freddie. There was no private label market at this point. We perverted the appraisal process and in perverting the appraisal process we moved it from a blind pool process to the appraiser as part of helping the deal occur. And you could say, well, why did we not see that on the back end? And the answer was because on the back end, the industry decided after massive REO losses in the late '80s or early '90s that it was better to keep people in their homes, modify the terms on their mortgages, and hide the losses by bringing people from delinquent to current without putting another penny in, okay? Even in the best periods of 2001, 2002, 2003, FHA redefault rates on modified loans were roughly 20 percent. That was in a period of massive appreciation where many borrowers would be able to re-buy into a new mortgage based not on the increased ability to pay but on falling rates. That said, I would say that this is not a housing crisis. To continue to define it as a housing crisis is to really miss the point.

In the fall of 2006, Alex and I actually sat here next door and we discussed the fact that we were heading towards a massive credit crisis, and that that really was driven by some fundamentals that people had been in and continue to misunderstand. This is not a housing crisis; this is a credit crisis, plain and simple.

If you look at ownership rates which were 64.5 percent in the early '90s, they rose to about 69.5 percent by the turn of the decade, the turn of the millennium. They have not really budged from there. What happened? How is it that home ownership has not really

changed if we have all of these great increases in homes sold per year? Well, what happened was that we were in a period of an exceedingly long period of low interest rates. Debt investors, especially charter-constrained debt investors, were having a harder and harder time competing with equity investors or non-charter-constrained debt investors. And Wall Street put in front of them this wonderful tool called securitization which has unfortunately been thrown out with the bath water and holds terrific value and is incredibly important were there clear, concise, industry standards and definitions, which there still are not. And that is important.

So all of a sudden investors were able to buy CDOs, providing them enhanced yields. The CDOs were the single largest buyers of mortgage-backed securities which drove Wall Street's willingness to create warehouse lines of credit for lenders. And that competition caused increasing mortgage originations and lowering of underwriting standards and innovation of products. That is the root of the crisis. To say that this is contained to housing is insanity.

And so early in this crisis when I wrote a paper on exactly this issue which I presented somewhere else in Washington, I highlighted the fact that this was not going to be contained to subprime. It was going to extend to all collateral asset classes and that that really is the thing that we need to solve for. The problems here are the leverage employed, the lack of standards. If you actually were to stop and think about it, even if we succeed in efforts to restore bank solvency, remove troubled assets from their balance sheets, provide banks with capital to lend and artificially stimulate demand, we will still have to re-ignite capital market demand at credit levels above those that depository institutions can support.

In 2007, almost a trillion dollars of collateral was financed and backed in the ABS markets. That is gone. So we can pump all the money in, we can worry about inflation, but the reality is that the gears of financial intermediation are non-existent, be it in the banks or in the capital markets.

Now let's step back and actually remember the lessons of the Great Depression. The Great Depression, we can argue whether it was actually the government acting too late. We can argue whether it was that the government held rates too low too long. We can actually recognize one thing for sure, which is that the real symptom that caused the problems to persist for a long time was the breakdown of financial intermediation. And just as the Fed in 1928 into August of 1929 increased interest rates in an effort to stop excess speculation in the markets, and succeeded in doing so as witnessed in October of '29, we had the same effects happen here, which is we had 17 interest rate increases between 2004 and 2005. That was the pricking of the bubble.

I'm not a magician. I'm not a genius. That was what caused me to ring the bell at the top in the third quarter of '05 and in the first quarter of '06 to say that within 12 to 18 months, we were going to have a 200- to 300-percent increase in default and foreclosure activity. Unfortunately, it is feeding through the entire anaconda at this point.

In order to take care of it, we have to recognize it is not about housing. Housing was the most sensitive asset class because it was the most abused. It is in credit cards, it is in commercial, it is in commercial mortgages, it is in autos. This is what we have to contend with, and trying to stabilize housing at this point is a losing proposition because every penny that we spend on stabilizing housing, as those other asset classes deteriorate will result in further destabilization of housing. This is a consumer-led, not a commercial-led recession or early-stage depression, depending on how close the razor blade is to your wrist. And we need to really think about the fact that we cannot stabilize until we actually clean out the bad assets. Every penny that we give a bank that still has diseases is a penny that will end up being used to support regulatory capital, not market-efficient growth. But even again with that, we have this other problem.

So the current conversation turned from the Fed after long-term capital for a decade telling us that they had learned great lessons from long-term capital. They believe that there is no longer any institution that was too big to fail, that we could circle exposures and wind them down with liquidity added by the government over time. And we saw under the last administration, I would almost say the Paulson doctrine turned out on its head suggesting that there are institutions that are too big to fail and that we should allow to be too big to fail.

And I think we need to recast that question. Are they too big to fail or are they too big to allow the abrupt destruction of counterparties, of depositors or of market functions? And those are very, very different concepts. So even as we are talking about the various approaches being used right now, I would argue that with all that the Treasury has done, with all that the Fed has done, some of the programs of the Fed have been very helpful, we need to continue to expand liquidity because at the end of the day, what we need to do is make sure there is enough there to clear leveraged derivative exposures. And that means that the only way you are going to, as an example, clear even a matched CDS which should clear -- right? There should be no cost, but you need to have the money in the system to allow the clearing if everyone has to clear at the same time. Or you have to say everyone is going to clear out their exposures at \$0.60 on the dollar, not a dollar. One is deflation, the other is printing to make sure these exposures can actually cross. So that is the choice. And so we need to continue to add the liquidity.

That said, while all of these programs are being put in place, while this concept was being played out, the FDIC really, I think, in two very discreet and somewhat intelligent moves to my mind, put the concept of "too big to fail" back in the box. And yet we are still not hearing anyone step up, recognize it and allow us to resolve large failed institutions with that in mind - what?

There are typically two causes of systemic risk in large institutions. The first is deposit runs. Well, what happened at Washington Mutual, that is essentially what happened is you had a deposit run. It was not with retail deposits. It was largely with non-interest-bearing-account run. But the FDIC has, over the past several months, put in place temporary guarantees that insured the retail deposits up to \$250,000 and non-interest-

bearing accounts to any limit. So there is really no rational basis for any deposit run at any regulated financial institution.

What is the other basis of systemic risk? Historically, the other real basis is counterparty exposure and counterparty risk and the contagion risk that they engender. And at the end of last year, the FDIC approved a rule on qualified financial contracts that should allow that risk to largely be ameliorated as well. And essentially what it says is if you are a troubled institution - and we will redefine "troubled" for the purposes of this rule which I'll explain - if we come to you and tell you that by the end of business you are going to give us all of your qualified financial contracts, all the supporting documentation, the names, contact numbers of everyone on your team and on every counterparty team, the FDIC will be in a position to actually start looking at counterparty exposures, aggregating them by counterparty, looking and seeing if those counterparty exposures are appropriately collateralized. If they are, they could be moved into a good bank in a typical FDIC resolution. And if they are not, that creditor, that counterparty becomes a creditor of the bad bank. Those are actually the mechanisms by which we can actually deal with failed institutions.

Now I think a lot of what we are seeing here is actually the traditional, typical Washington regulatory turf war over charters. I think we need to actually stop and call it as it is because even in the bad bank right now, and the bad bank discussion that is going on, there have been two approaches. There is the approach that we used in Citi, in AIG and in Bank of America where you ring-fence the assets, leave them on the balance sheet and essentially say that you have addressed the problem. And then there is the bad bank or even in this, what we are talking about now, an aggregator, a mega-bad bank. Call it bad bankydon [sounds like] something. And I think they are very different. So if you are going to just circle the exposures - as we have seen in Citi - it has not really increased confidence for market participants because we do not know what the exposures that were circled are. More importantly it actually creates a further disincentive of public and private interest. Why? Because if the value of those assets recover and they remain on the balance sheet of the troubled institution, who gets the benefit when the assets ultimately recover? Not the taxpayer who put their capital on the hook to support that institution.

So what is the more right answer? How shall we look at this? Well, I would actually argue - and I think that many here would agree - that we can actually resolve any institution. And it does not mean that, as an example, the dealer disappears. It means that we separate the institution into a good bank/bad bank and deal with it the way the FDIC deals with every institution. And we de-politicize what has become a deeply troublingly politicized process. That is not going to happen unfortunately.

So where are we? Well, we are hearing all sorts of things flowing out of Washington, balloons being floated about, the good bank versus the insurance rap. It appears that one group of regulatory powers is in favor of the rap and the others are in favor of a more traditional resolution. And where are we heading? We are heading towards a compromise. Well, you say, how can you compromise? Those seem to be two different

things. Well, the compromise seems to be between a long-term fix where every bank has to actually write down its exposures, recognize its losses - and we will get to pricing, if we can talk about that - and move forward or something other. Now what is the something other? Well, how about if you only actually have to take or sell to the bad bank assets that are available for sale or in trading? But held-to-maturity or accrual assets remain on balance sheet and we will either come up with a standardized insurance rap product, or we will deal with them on a one-off basis. That sounds --

Alex J. Pollock: Josh, one minute.

Joshua Rosner: -- that sounds like we were heading into very dangerous idea. Most of the troubled in our institutions going forward are in whole loans held to maturity, are in the loan book held to maturity and on the assets that were moved from available-for-sale or trading to there.

So I think it is time for us to actually make a clean break, go through the pain in a concerted rational effort, have the government share and we can even structure, by the way, the back end of the funding of the aggregator bank so that there is a trunch where the government shares in the profits with the institution that sold, where the government actually passes the losses on when we see the amortization of those losses to that institution from whom it purchased the assets. There are rational approaches. Unfortunately, being in New York where I watch Washington from the outside, we are probably not going to get to that point.

Alex J. Pollock: Thanks, Josh. Walker, who does not represent New York.

Walker F. Todd: I represent Ohio in those ways. Also I need to give the disclaimer on this representing stuff that my remarks are entirely my own and not those of the American Institute for Economic Research.

Let me lead off with a guessing game. Who said this about a year and a half ago, "Americans should be outraged at the latest sweetheart deal in Washington. Congress will put you as taxpayers on the hook for potentially hundreds of billions of dollars to bail out Fannie Mae and Freddie Mac?" Then later he said, "If a dime of taxpayer money ends up being directly invested, the management and the board should be immediately replaced, multimillion dollar salaries should be cut and bonuses and other compensations should be eliminated. They should cease all lobbying activities - in Washington you can hear the heart attacks beginning right there - and drop all payments to outside lobbyists. And taxpayers should be first in line for any repayment." Who said that? In the back?

Male Voice: Barack Obama.

Walker F. Todd: No, wrong, about 180 degrees wrong. John McCain, okay? Now that was before the rubber met the road in September, of course, when we saw what Senator McCain did then. Not to defend his later behavior, but I think John McCain had it largely

right when he was speaking these words in the summer of '08, July of '08, as Fanny and Freddie were sliding toward their eventual resolution.

On the lobbying point - has anyone here ever heard of the Byrd Anti-Lobbying Amendment? It is statutory. It is entitled 31 of the U.S. Code, the Treasury Code. Look it up. It says that any agency or entity that receives appropriated funds from the Treasury is prohibited from lobbying Congress or the executive branch. Now, of course, this thing is probably the most widely ignored statute on the books, but let's get with it, folks. Why are we still allowing the recipients of TARP money to still lobby anyone in Washington? I want an answer to that sometime.

Next, let's move on to the regulatory errors over the years. How many of you have looked at the Group of Thirty report that was issued on the financial crisis about a week or two ago? I need a show of hands, anyone seen the Group of Thirty report? Who is the principal signatory on that thing? Paul Volker, and of course he plays a major role in theory and financial advice given to the Obama administration. Other notable signatories on the report were E. Gerald Corrigan, Steve Thieke and others. Well, you read the report and it basically says, well, we are in a powerful mess. There were an awful lot of regulatory errors over the years, but we really cannot bring ourselves on this point that Mr. Ritholtz was making a moment ago, we cannot really bring ourselves to break up the two big to-fail banks. We really truly desperately want them to remain big. And the parenthetical remark is that seems to be because the Fed, the Treasury, et cetera prefer having really big banks headquartered in New York or Charlotte or wherever so that when they want to move on a policy front - they, the Treasury and Fed - they only have to place a few phone calls, and they can get 60 percent of the heavy lifting done instead of having to make hundreds of calls across the country.

Well, anyway, so they are saying we cannot break up the big banks. So the gist of the G-30 report is let's recapitalize these existing banks with the existing managements remaining in place and no extreme dilution of the existing shareholders. And in return for this, we promise we will do a better job of regulating the next time. Do you want to buy that? I was talking to a female reporter in Cleveland about this issue yesterday, and I said, "Let me ask you this: How many times would you, a woman, take back an abusive husband?" She said, "Maybe once." These guys who wrote the G-30 report are the very regulators who, on their watch, four times in the last 26 years have allowed the biggest banks to march the financial system to the brink of systemic ruin, and they are saying, "Give us another chance."

The aggregator bank, the RTC-type proposal - I cannot tell you where this comes from, but it comes from deep within the bowels of the system. I was asked, "What is the main point you want me to make here today?" The aggregator bank is being marketed to you, Washington types, as the second coming of Bill Taylor and the Resolution Trust Corporation. It is not. In your folder, you have an article I wrote under Old Reconstruction Finance Corporation. The second half of that article is about the RTC and its structure and where it came from. And by the way, there is a plan for a reconstruction finance corporation on pages 27 and 28 of that article if you want to know

how to go about rebuilding an RFC, which would be a good idea. The old Resolution Trust Corporation - picking up on the point that Mr. Whalen will make after me also - inspected first and put money in afterward. That is what has been missing all along, dealing with the points that Josh, in particular, was making. So far, everybody in Washington is talking about solutions that involve let's-put-taxpayer-money-in-first, and maybe someday we will get around to inspecting the assets and the institutions that we are rescuing. From a taxpayer perspective, is that not ridiculous? So I want inspection first.

The original RFC was a plan devised in the 1930s to deal with rescue efforts, restructuring efforts coming from all sectors of the economy. We have already seen that in the last several months who has been to Washington, asking for rescue, and it is not just banks. It is not just mortgage lenders. It has been the auto industry, the homebuilding industry, the luxury homebuilding industry, the commercial real estate development industry and even Larry Flynt and the porn industry.

Well, it is pretty obvious that when rescue time comes to Washington, it is like a pork fest squared, and the -- so everybody comes, hoping to get some of the benefits that are going to flow down off of that Christmas tree. I do not want the Federal Reserve spending its time thinking about that. Lord knows they have enough to do to get monetary policy straight, picking up on the points that, I think, Mr. Ritholtz made about the ballooning of the Fed's balance sheet. I do not think they fully understand what they have done or the eventual consequences of what they have done. I want them to focus on that instead of picking winners and losers in an industrial-style policy that looks an awful lot like Benito Mussolini's corporate initiatives of the 1930s that we imitated in the New Deal. I do not want the Treasury Secretary picking winners and losers necessarily either because he has enough to do to refinance the public debt.

In the '30s, they tried letting the chairman of the Fed run the RFC for a while, and eventually they understood it cannot be done and they split them off. They picked a man named Jesse Jones - some of you the older guys may remember him - and Jones was a piece of work. And you would have to think very carefully about picking a Jesse Jones today to run such an agency, but I have some nominees in mind who would do the job. It would not do them any good for me to name them here today, but they exist.

Do not swallow that nonsense of if we fired all the bank managements, where would we get replacements? I personally know 25 people who are competent to run the 25 largest banks. I know bank examiners from my generation who seem a little old, and most of the guys, except Alex, of course, who are up here on the panel. But I know bank examiners who would be very good as chief auditors to clean out this mess or who could, if called back into service, help out the Fed, the FDIC, the OCC or whoever has to deal with this.

It can be done, but people in Washington do not want to face up to what has to be done. You are afraid of hearing the bad news. Party is over. What? Stop the lobbying? Heaven help us. Mark the assets to market first and then put the money in? Lord, help us. How will we ever get anything done going forward?

The Fed, in expanding its balance sheet, has relied primarily on a very obscure section of the Federal Reserve Act - Section 13.3. It was passed in the 1930s, and it was passed during the year when the Fed was trying to do all things for all men and run the RFC simultaneously, but '35, '36, they had given up that exercise. Thirteen-three essentially was not used between 1936 and 2008.

In 1991 in the dark of the night, the Federal Reserve Act was amended as part of the FDICIA Act that year, the FDIC Improvements Act, to give the Fed the power to make loans in an emergency to any individual, partnership or corporation on non-traditional forms of collateral. I wrote an article then, saying, "That gives the Fed the power to make loans to an investment bank." That article is in your folder also. It did not happen for 17 years, and at the time, I was severely criticized and indeed reprimanded by senior people at the board staff for writing that article. But it happened, did it not?

Today, if you look up and down the line at the sided authority for all the new lending programs the Fed is engaged in, the usual citation is section 13.3. To paraphrase a remark that Thomas Jefferson made to Washington when he was reviewing Alexander Hamilton's plan for the National Bank - Jefferson thought the plan was unconstitutional - he said it relies too much on the necessary and proper clause of the Constitution. If we accept this interpretation of the emergency as a usual form of procedure, you may as well throw out the rest of the Constitution Jefferson wrote and rely on that one clause. So it is today with the lending activities of the Fed: You may as well shred the rest of the Federal Reserve Act and keep only section 13.3, letting the board make all the decisions on an emergency basis. And by the way, if they can do it on an emergency basis, that means the board alone gets to decide everything. The regional reserve banks are not consulted, and yet, gee, the bad assets that the board takes in are far and back out to either the regional reserve banks in some cases or in most cases they are parked at New York or occasionally Boston, one of the friendlier reserve banks. The New York Fed is now leveraged to 100:1 on its balance sheet. The system as a whole is leveraged 50:1. The regional banks like Cleveland are about 28:1, a hundred to one at New York now. Think about the loss-absorbing capacity there.

No one should be too big to fail. I agree with Mr. Ritholtz on the concept that we need to do something fast and across the board to get our arms around the magnitude of the problem. It will be less costly in the long run, and you will have a healthier banking system emerge out of it if you can just bring yourself to do it. So I was asked the other day by another reporter, "What do you favor?" and I said, "Well, I like the concept of the Reconstruction Finance Corporation. Read the plan and there you will see the main way it operated was to do an inspection first, mark everything to market, and then put the money in." Nationalization, the concept that he discussed, also could be used to accomplish the same thing. Now, to be sure, when you speak of nationalization, you have to make it clear - you are talking about temporary nationalization - 30 days, six months, a year, three years max. And then you have to try to put that remaining bank back out into private hands. So the efficiency of the system, it cannot be sustained longer than a couple of years in a political environment after all.

But a lot of people, of course, when you say nationalization, they think you mean permanent socialist ownership of the biggest banks. No, do not go there. The third concept is worth thinking about. As a last resort, when everything else fails and you are approaching a trillion here, a trillion there, three trillion maybe, four trillion thrown at this problem, would you consider a bank holiday? Bank holiday, a friend of mine calls it the poor man's RFC in the sense that you close everybody at once, inspect them all, you only allow the solvent to reopen, and you know the size of the problem that you confront with recapitalization. It is not so bad if you could hold it down to just a few days. And one of way of holding it to a few days is you exempt Sheila's List banks. Remember, there are a lot of banks, mostly community banks, that have opted out of the FDIC's guarantee program. That list of banks who have opted out is available on the FDIC's website. So you do not have to inspect them on day one theoretically. You start with the biggest banks, and in one-day inspections, you can do it. I have been on teams of bank examiners that have done this. We went in to a pretty big bank, and we have managed to inspect assets worth 60 percent of the balance sheet the first day. You can get your arms around this problem if you want to, but of course it is Washington and no one wants to.

Finally, to wrap up, a concept that Alex promotes - I endorse his concept of a homeowners' loan corporation. You can run it through an RFC or an HOLC, either one will do. I would have preferred the Obama administration to say, "We are going to reform the entire consumer-lending structure." For three years, we are going to have one standard mortgage lending form, not just the disclosure form that Alex has promoted but one standard mortgage lending form, one standard auto loan form, one standard credit card agreement, et cetera. And after three years, we will take the restraints off and let the market operate again. But you are not going to clean out this mess until you are willing to confront the task ahead of Washington and begin to do some of the things that I have outlined.

Alex J. Pollock: Thank you, Walker.

Walker F. Todd: Thank you.

Alex J. Pollock: Walker and I, I'm quite sure, first discussed the Reconstruction Finance Corporation in 1991, it must have been. Anyway, coming to our last panelist, Chris.

R. Christopher Whalen: Thank you, Alex. And again, on behalf of Professional Risk Managers and our D.C. chapter, I want to thank American Enterprise Institute and Alex for yet another successful collaboration.

Starting as a young man in Washington, I had advantages that many people do not because I am the oldest child of Joan and Richard Whalen. And my childhood is filled with memories of presidents, Fed chairmen, ambassadors and secretaries and this and that, coming and going at all hours of the day and night, many of whom would spend many hours in our front salon, talking, drinking and making policy. My dad, in turn, had teachers of his own and mentors during the several decades where he was one of Washington's most celebrated and least noticed agents of influence. One of those

mentors was a fellow named Arthur Burns, who many of you remember as chairman of the Federal Reserve board. One day, Chairman Burns said to my dad, "Dick, whenever you are going to make a speech, make sure that you number your points. It makes you look like you actually have a plan. And do not tell Connolly."

Now, Chairman Burns was talking, of course, about John Connolly, and he had been invited to a very big event where both he and the secretary are going to speak. Indeed he did. And the next day, in the very compliant media, you saw Burns' four-point plan, and down below about halfway down in this story, it was also mentioned that Secretary Connolly had spoken as well.

I think what I'm trying to convey to you is that unfortunately, as Josh and some of the other panelists were saying to you, the ad hoc approach has been dropped, and in its place at the moment, there is nothing. Over the next couple weeks, I understand, a process is going to evolve and a new plan is going to take shape, but in between now and then, let me share with you, if I could, four things that I would do if I had the ability to do them. The first thing, as we have talked about before, is good banks and bad banks. I think we have covered this turf pretty thoroughly today, but let me put it to you in context. I got a call from my friend Nouriel Roubini, whom many of you remember from our other series, *The Deflating Bubble*, which we will be reconvening on St. Patrick's Day this year, which I think will be very appropriate. And Nouriel said, "Chris, I have this number for charge-offs of commercial banks and broker dealers, numbers into a little over a trillion dollars for the next year. Is that about right?" And I said, "Yes, that is around the same neighborhood if we go from, say, two percent charge-offs at the end of the third quarter," which includes WaMu, by the way. WaMu is not in the FDIC's numbers at the end of the third quarter. Look at the footnote. Where will we be by next year? I think by the end of the fourth quarter next year, U.S. banking industry could be at four, maybe four and a half percent charge-offs for the entire industry. That is twice 1990. In other words, by the end of this year, when we get the data in three weeks, I think the whole industry is going to be at losses of charge-off levels that are about where we were in 1990, and we are going to keep going.

So what do we do? Well, the good news is that about two-thirds or three-quarters of that trillion-dollar loss number comes from the top four banks. Do I have everybody's attention? What that means is, yes, the problem is identifiable, and it is containable if we have the courage.

Unlike Europe, if you look at the OECD report that has been alluded to a couple times today, you will see that there is still a lot of material to work with in the United States in terms of a banking industry that we can rebuild our economy on. We do not have that in Europe. There may be nations in Europe that have no banks other than those that are government-owned. Think about that. There are no new banking charters being created in most European countries. We had over a hundred new banks created in the United States during 2008 - kind of surprising, huh? I have a list out the door, by the way, of private equity funds and other people who want to buy banks, and they were all hiring my

firm, by the way. In fact, we had our best month. January is going to be our best month in our company's history, so just a little bit of sunshine there.

If you juxtapose what is going on in town today, which is basically the Fed and the OCC trying to rescue and preserve what is left of the sale-side banks in New York, with the mounting opposition to this view, it is coming from places like the rest of the banking industry, who stand in front of you, by the way, in terms of loss absorption. We have already raised FDIC premiums. And I have to tell you, those community bankers are going to be living at Washington by June. These are not happy people because they look at New York, they look at the situation Walker described where we have given the New York banks how many passes? Three. There is my friend Bob Feinberg, who is in the back there, has said many times if we had resolved Citi in 1990 or 1991, we would not have this problem today. The bankers would have been put unnoticed, and we did not do it because we did not have the guts.

And the Fed, of course, was doing what they have always done, which is a very arbitrary and capricious rule. We need to eliminate that institution, at least insofar as it is involved in bank supervision in this country. In fact, that is the one thing I heard Barack Obama say on the campaign trail that made me just delighted. I would turn into a liberal Democrat tomorrow if he would do that.

Walker F. Todd: But the bill is going to give it all to the Fed, is it not? [Cross-talking]

R. Christopher Whalen: We will see. I'm an optimist. Let me just, with respect to bad banks, say one last thing and I want to move on.

In our Constitution, we have a mandatory requirement that the Constitution put bankruptcy where? In the federal courts. Why did they do this? Because in the 18th century, when you gave a federal judge life of power and debt over insolvency, you basically took it out of the politics. There was nobody in this country who would even look crosswise at a federal judge until this century. They were the absolute power outside of the east in this nation for a century.

But today we have, of course, ultimately politicized this. The first politicization, really, if you think about it, was the FDIC, this special chapter of bankruptcy just for banks. And now, with too big to fail, which my old boss, Gerry Corrigan and others have developed - - and I urge all of you, by the way, to go to my website, RCWhalen.com, and read the paper by the Herbert Gold Society that was published in 1993 called Gone Fishing: Gerry Corrigan and the Era of Managed Markets. When you read this paper, you may not think as much of Paul Volker as you do before.

All right, second issue - market structure and credit default swaps. I have been talking a lot about credit default swaps for a while because to me they represent the epitome of idiocy on Wall Street. We took what was already a stretch, which was the over-the-counter market for things like currencies and interest rates and all of that. Then you can argue good or bad. But at least in currency swaps, interest rate swaps, all of that, there is

a basis. You can look at the cash market for yen. You can look at the cash market for dollars or other currencies, and you can get a sense between the forwards and the futures and the options in the futures that there is some rationale operating here.

The trouble with credit default swaps, though, is that this represented the Fed's overreach in my view. They had already blessed the over-the-counter derivatives market as a way of keeping the big banks alive. This was their swap because they knew that as the banks get bigger and bigger, they are less profitable. Remember, Martin Mayer, what did he teach all of us years ago? There are no economies of scale in banking. You either know your customer or you do not. And if you are in a big bank and you are relying on FICO scores and statistics rather than, as our colleagues were saying, the fellow who walks into the branch and you have known him for 30 years, that separates the two business models, does it not? That is why I tell people that two-thirds of all banks in the United States are probably going to be okay. They may get kicked around. They may have to merge, but they are not going to look like the New York banks. It is a totally different business.

So when you look at it from this perspective, when you look at the over-the-counter derivatives market, you look at the way the Fed and the OCC have encouraged this, and then you look at the spectacle of the last year with the dealers, the DTCC and the Fed spending billions of dollars worth of man hours to collapse half of the market that has no problems. We have torn up \$30 trillion with the credit default swaps in the last 12 months. And I owe you all an apology. I have sat here before, beating up hedge funds for taking naked positions in credit default swaps, and there are some that did this. But you know what, some of my biggest clients are hedge funds, and these are some of the best managed firms in the world. You know why? Because they all have partner money in the firm. These firms are not allowed to write CDS without full collateral. You know who does not have collateral, it is the goddamn dealer banks, and the Fed has known this all along.

I'm sorry, Alex. Penalty. Well, I used the term vicious weasels last time, and I did not get a penalty for that. So I forgot what I was talking about. I think it was the Fed.

Anyway, so bottom line is I think credit default swaps have to be rationalized. How? I think we are going to end up with an exchange traded option that tracks the corporate bond that the trader would like to hedge because remember what we are talking about here with CDS is a contract that says if this goes to defaults, you have to pay me the par value of a bond that you cannot borrow. There is no market for most corporate bonds. Once they have been placed, they do the deal and they underwrite it, they are placed with investors. They almost never trade. So you have a security for which there is no basis. There is no visible market for this bond. It almost never trades, and yet we came up with this marvelous contract based on currency and interest rate swaps that instead of settling in cash that used to settle, well, you had to deliver the bonds - not anymore. It all settles in cash.

So I think what we have to end up with is an exchanged traded product for the traders who are mostly focused on volatility day to day. And then I think we have to end up with

an insurance product that is fully collateralized. And you know what, when I talk about collateral, I want to see 50 percent of the difference between par and what the market says the recovery rate on the bond is today. Most dealer banks will never play there because they do not have the capital. That is the market for the insurance industry. In fact, it looks just like municipal bond insurance. We will let the market decide if they like that product or not, but what I am saying --

Alex J. Pollock: You have to watch your time.

R. Christopher Whalen: Yes, sir.

Fair value accounting - I like market prices. I think market-based pricing is a very important thing, but I also work with a lot of people in the audit sector. And I have to tell you, based on my experience with other evangelical and religious movements within the audit sector like XBRL, I see the same crazy look in the eyes of people when they talk about fair value accounting. In fact, I think fair value accounting is the last remnant of bubble thing that we have to deal with. And why do I say this? Because these innocent, beautiful, intelligent people, these pure people who sit on the board of FASB somehow or another never realized that they were riding the wave of market efficiency, that markets are efficient, rational and complete. Read the interview I did with Bill Janeway, by the way. It is on our website, the former vice chairman of Warburg Pincus, teaches at Cambridge College there.

We have to gently take the accountants away from this aspect of policy. Letting accountants be standard setters is a really bad idea because they said when they enacted this rule, it may cause some volatility to earnings. Yes, indeed. I do not think there is a human being alive here who can react daily to changes in market prices and asset prices and have a rational understanding of what they mean, but that is what we have done. That is exactly what we have done to our economy. I actually think we should thank them in a way. They deflated the bubble faster than it might have otherwise deflated. And I do not pretend that they created the excesses that we are dealing with now, but I do think that fair value accounting is accelerating the problem. And we can sit here and pretend that it is not and watch many of our financial institutions liquidate it this year, or we can get the adults back in the room and we can take control of the situation.

I would disclose both. I want to see the historic cost of assets and I want to see the inter-period movement in prices. And if the prices move down and they stay there for a couple quarters, then write it off. But how on earth are we going to have financial institutions, pension funds, insurance companies which historically are supposed to be indifferent to short-term economic cycles, if we are going to subject everybody to an asset fire sale test every day? I do that with corporations for my clients, by the way, and it is a distress test. So fair value, believe me, folks, is a distressed standard. It basically says everybody has to liquidate today. We cannot survive that way.

Alex J. Pollock: One minute?

R. Christopher Whalen: One minute? Thanks, Alex. Could I buy my two minutes back?

Male Voice: Josh and I had champion [indiscernible] --

R. Christopher Whalen: I know.

Male Voice: -- especially on fair value.

R. Christopher Whalen: I know. It is okay. There are no answers. That is the one thing you have to understand about financial analysis. Anybody who works with numbers will always tell you that there is no right view, Alex Pollock. I like having two views. Give me a book in market; we may even come up with another one, but remember that each one of them is wrong. When someone comes to me and says to me, "Chris, use the rating for this company." No, one rating is not enough.

Male Voice: That is not a dynamic institution.

R. Christopher Whalen: Hush, I did not interrupt you. Just quickly and I'm going to shut up because you can read my beautiful text that I wrote on the train. At the end of the day, when I look at a bank, I look at their nominal performance. So JPMorgan, they are an A right now, but then I look at their economic capital numbers, and JPMorgan, my computer does not like them. My computer wants \$4 of capital for every dollar they have now. That is why a multiplicity view is as important. There is no one right view. And when the guys at the SEC or up on the Hill or the bank regulatory agencies say, "Well, I know what the truth is," you know they are wrong. When they lose scientific objective skepticism about their own work and say, "Hey, I have the answer," then you know they are wrong because I will tell you right now, I spend almost all my time on U.S. banks and I'm not sure about any of them. That is how radical the situation we are in is and now. So with that, I will be quiet and let my friends tear me to small pieces.

Alex J. Pollock: Thank you very much. I think we will all agree that was a very stimulating set of presentations. I have to tell one story, which I'm sure Walker knows, which is that the bank holiday, which I do not recommend, was considered by Herbert Hoover in early 1933 when he was still president. But he was advised by his attorney general that it was illegal and that he could not do it. He discussed this idea with Roosevelt, the president-elect, and asked for his cooperation in working something out which Roosevelt refused. According to the story, Roosevelt then went back to his own office, called in his guys and said, "As soon as we get in, we are going to have a bank holiday." And they said, "But we understand the attorney general has ruled that it is illegal," to which Roosevelt replied, "My attorney general will rule that it is legal." And he did. And I wonder how many of us remember which law was used to justify it. It was the Trading with the Enemy Act of 1917. So it takes, sometimes, creativity.

Let me give the panel a chance -- and gentlemen, these have to be brief replies. I mean really brief. But let me give the panel a chance to reply to each other before we open the floor. Anybody?

Joshua Rosner: I have few points. First --

Alex J. Pollock: Turn on your mic.

Joshua Rosner: First of all, I think actually structured finance has gotten a very dirty name because of lack of standards, lack of clarity. Structured finance are mathematically-derived securities. These are static pools of assets with finite lives, and there are mathematical truths to them unlike a corporate structure where there is dynamic and management can change outcomes based on the buying and selling of assets, labor union decisions, et cetera. So I do think that there is a big difference, and by the way I would also disagree because if you do not want to mark your book every day or every period, move it to held-to-maturity. Then you only have to worry about other than temporary impairments. That has already been accounted for in the accounting laws. So that is one.

Two, I actually forgot, and I think it is really important that we discuss this and that people in Washington understand that this is a game that is being played - there is a lot of discussion about how we recapitalize these institutions after we take the bad assets off. Do we take equity warrants? Do we take equity? And I would point out that taking equity seems to be the leading approach by those who want to keep the large banks alive, but it will also make it politically impossible for the safety and soundness community to ever wind down institutions if they need to be wound down because the rest of the political regulatory community will say, "You cannot wipe out taxpayer equity." The more appropriate way of doing it would be for the government to buy senior preferred, cram down the existing preferred to wipe out the equity, and that becomes the new equity. That is the appropriate way of doing it, and I think we need to put that into the mix here.

Alex J. Pollock: Thank you, Josh. Other comments from the panel? Barry.

Barry L. Ritholtz: I just wanted to briefly touch upon mark to model and mark to market. What always get lost in these discussions, there are really two things. First, when the market was going up, none of the banks had problems marking to market every day. It is a ratchet wrench. As long as it is a winner, we will mark to market, but as soon as it heads south, we have a problem with this fair value accounting. That is just hypocrisy and reflects the vicious weasels running the company, to quote Chris.

But second and more importantly - and this gets lost all the time - the equity market is a broad and deep market. It is 30, 40, 50 trillion, depending on where we close that day. The bond market is twice as big. The currency markets are another four times that size. If you want to trade stuff on a daily basis or at least own stuff that there is a deep, broad, reliable price for, you can. And what gets completely overlooked in all these mark-to-market discussions is someone made the decision to buy a whole bunch of hard-to-value, thinly traded, no-room-at-the-exit paper, and there is a penalty for that. And what that penalty is as soon as there is any trouble, everybody rushes for the door.

There is a reason most hedge funds do not focus on Star Wars collectibles and Beanie Babies, with the exception of Madoff investments in company. The reason is you want to know that you have a bid. I'm sitting on a billion dollars. I have to have X percent liquid to sell when my redemption comes along, so therefore I'm going to stay away from crap paper, eBay collectibles and other junk. And a lot of this paper, you can own a teeny, tiny percent if you want to play in that area, but to say, "Hey, 80 percent of our holdings are going to be this pile of let's call it fertilizer," that is a decision that needs to be punished. The fund manager needs to be punished; the board that tolerated this needs to be punished; the risk manager needs to pay for their culpability. So before we focus too much on mark to model and mark to market, remember, someone said, "Hey, I'm going to buy this thing and I do not know if I'll be able to sell it, but I'll blame the accountants when it all goes to hell."

Alex J. Pollock: Other comments from the panel. Tim.

Timothy S. Bitsberger: I'm curious. I do not mean to be sarcastic and rhetorical here, but how many people in the audience have ever traded a CDO or CDS? That is good. How many people can get on a whiteboard and explain to the audience how a CDO, CDS squared is trunched and where the different levels of leverage come into play. On the panel or audience, just to -- less than five. I think when it comes -- here we are and we are talking about valuing these assets and should it be fair value or mark to market, and having traded this stuff and seeing how it is modeled and spending hours on Bloomberg, trying to get into different pools of mortgages and how they are all valued, it is incredibly complicated stuff. And with all due respect, to try to unwind what these banks hold -- and 2009 is very different than it was 15 or 20 years ago. And I think what we are trying to figure out is that the layers of this complexity that the banks, for stupid reasons and they should be punished and I agree with all that, but I question the assumption that this is something that we can easily get our hands around and solve because a lot of the CDS, CDS squares are based on model assumptions and just because where the price clears is not necessarily a reflection of its economic value. And unfortunately that economic value is based upon a model.

Joshua Rosner: But that also --

Alex J. Pollock: Hang on. We are going to give the audience a chance. We have all had a lot of fun up here so far. Now, my goodness, we have lots of questions. Karen, where is my microphone here? Here is how we are going to do this. Please wait for the microphone. Tell us your name and your affiliation, and then ask your question and then we will take as many of these. We will start right here, and I'll work to my left. Is that on? Not on. Karen. No? Maybe you could stand up and talk loud.

[Audio skips 01:39:28 till 01:39:54]

Male Voice: -- but in which case, [audio skips] on the basis of these institutions converting to a different asset class.

Alex J. Pollock: Thank you. Just for those who did not hear that, the question is about bankruptcy, and in particular about converting debt to equity, which is that is to say the creditors' money becomes equity. Anybody want to comment? Chris?

R. Christopher Whalen: Well, one of the things I did not touch on is that if you take Citi, I think it is absurd to be talking about equity at this point. If you even take a reasonably modest loss rate assumption on that institution, say, 20, 25 percent, which I think is low, you are talking about wiping out tier-one risk-based capital a couple times, even with the TARP money. So from that perspective, if I were sitting in Congress, the only thing I would want to hear from the Treasury is how much debt are you going to give me because I want to be a creditor of these institutions. I do not want to be a shareholder.

Alex J. Pollock: How about existing creditors, though, and existing creditors though, and turning them into equity holders?

R. Christopher Whalen: But you have to know --

Alex J. Pollock: I'm sorry. Is that what I said? Yes, existing creditors, the existing debt holders, bond holders.

R. Christopher Whalen: But this is the same problem I have with my clients now. They say, "Chris, I want to buy this bank. What do you think it is worth?" And my answer is, "Well, let's see what the loss rates are by second quarter of this year. Maybe then I'll feel like estimating what I think the peak will be," because then that is the only way we could give them an answer.

Joshua Rosner: Yes, except in there, I expect corporate defaults to reach record levels by the end of the third quarter or the fourth quarter. And construction lending tax will also have historic high charge-offs somewhere shortly thereafter. So even there, it keeps you hanging in the background, saying, "I'll wait until the dust has settled."

Alex J. Pollock: I'm going to take one more. Walker, I think you had a comment on this. You have your finger on your button. Let's go -- questions. Here, please.

Kristen Schuh: Hi, I'm Kristen Schuh. I'm an editor with Inside Mortgage Finance. What does all this mean for the securities market and what will become of this market in the future?

Alex J. Pollock: Are you speaking of the securitization market? Josh, and then [cross-talking].

Joshua Rosner: I think that one of the things that I think in terms of being a productive player here, look, we do not have a single standard of delinquency and default in this country, which is outrageous. We do not have a single standard of [audio glitch] standard pulling and servicing a rep and warranty program in this country, which is when asset prices were going up, no one cared to bother reading the PSAs, the pooling and servicing

agreements. And when things started going bad, everyone knew that there were dozens of different PSAs, but they did not want to bother reading them; they just ran from the entire asset class.

I think, actually, here is an area where the FDIC can actually show significant leadership because if we do a bad bank or however we do a resolution, they are going to have assets that need to be disposed of. They can be the single industry standard setter for these things, given the fact that American Securitization Forum and ISDA have been a miserable failure in their project restart approach.

Alex J. Pollock: Tim, comments on securitization.

Timothy S. Bitsberger: Well, right now, as was prior to 2001, the securitization market is FHA, Fannie and Freddie; all the private labels gone. I think the future of securitization should be bright, but the future of securitization as a way to hedge credit, I think, is bleak. I think pooling assets and trading them as a securitized product makes a tremendous amount of sense. But then creating derivatives off that as a way to create insurance or hedges -- it did not work, to Chris' point earlier.

Alex J. Pollock: Thank you.

Bert Ely: Bert Ely, banking consultant and one time bankruptcy consultant, trustee, examiner and so forth and someone that has a fair amount of experience with it. One of the things about bankruptcy, coming back to Walker's point, is the objective of the bankruptcy, and specifically in a Chapter 11 situation, which is where you try to have rehabilitation, is that a long-term point of view is taken and you have an interaction between management and creditors. Rather than liquidation mentality, a lot of what I'm hearing today is an almost punitive liquidation type of mentality that these people did bad, and we are going to punish them even if it costs the economy a lot of money. I would like some reaction to that, specifically in terms of the extent to which -- whatever we think of these companies as being villains that a bottom line for the economy and for the American people should be to minimize losses going forward even if it means that some people do not get punished as much as we would like. I mean, what is the panel's reaction to that?

Alex J. Pollock: Walker?

Walker F. Todd: I think I get the first crack. Remember my abusive-husband analogy. I'm willing to give these guys three shots at Chapter 11, but the fourth time, I think is Chapter 7 time. And this is the fourth time. And secondly --

Alex J. Pollock: Would you define the other three shots just for the audience, Walker?

Walker F. Todd: 1932 - third-world debt prices; '87 to '91 - real estate debacle; '97 to '98 - Latin America, East Asia, Russia long-term capital; and now today. So anyway, then the other response about this is I would be willing to buy the CEO and the board of

directors of each of the top nine banks a villa in Monte Carlo, if they would go there and never dabble in U.S. political matters or influence again. So the problem is if we do not - some of you are opera fans, I assume. In the ring cycle, remember that Fafner, the giant who gets the gold hoard, turns himself into a dragon to defend the hoard. It is better to go kill Fafner before he turns himself into a dragon, and in this case, if you allow these guys to come back again without putting them out of their misery, we will back here a fifth time within 10 years. I'll bet my life savings on it.

Alex J. Pollock: Hang on. I'm going to get with Chris and then we are going to take another question. We would all love to talk about this. Quick comment on bankruptcy.

R. Christopher Whalen: Going back to the historical American model, not the Swedish model, why did the founders put bankruptcy in our Constitution? Because they knew that finality was good for society. The longer we dally with the big banks, the less growth we will have. It is a very simple tradeoff. Shoot the banks fast. Let Sheila take care of all of it in the summer. Break them up and sell them. There will be a crowd of people standing on the other side of that receivership. Many of them are my clients. They all have shelf registrations with the OCC and the FDIC right now. You want to fix this? Feed the beast. Let them buy the assets, and the prices will go up.

Timothy S. Bitsberger: Why shield against their debt?

Alex J. Pollock: Hey, hang on. [Audio glitch]

John Serrapere: My name is John Serrapere with Foster Holdings and [indiscernible] researcher. Chris, last time we were here - I have been here for a lot of these - I talked about how fast things were moving and the ability for the Fed, Treasury and, I guess, the nation to manage the problem. I think Meredith Whitney indicated that once you get past 90 percent or approach or exceed 90 percent unemployment that these losses will eventually wipe out all bank capital. And I'm confused about what the numbers are. I think the existing numbers are like a trillion in losses, plus we were looking at another trillion sometime this year or half trillion. But if you get to that number - I'm reading your stuff, I'm reading Nouriel's stuff, I'm doing as much research - I'm thinking if that is the trigger point and if we get there fast, what do we do?

Alex J. Pollock: What is the relationship here with the unemployment, Josh [audio glitch]?

Joshua Rosner: And that is actually -- yes, we would wipe all the capital, but that does not mean that it is across all institutions. Let's actually quickly remind people why we have the healthy banks, the smaller ones and the unhealthy, the large ones. The healthy banks - and to answer your question also, Bert - there does need to be something punitive in the sense that the banks bought these structured instruments because of regulatory arbitrage, because regulatory regime treated RMBS the same as a home mortgage, and it was not; it was a leveraged exposure. So the big banks are suffering from coronary disease and imminent heart attacks. The small banks are suffering typical cyclical

degenerative disease and flus. So that is really the difference. So, yes, it will wipe them out. And I think that the unemployment question, if you go back to the way we calculated it in the '30s, we are already at 15 percent.

R. Christopher Whalen: Let me throw in a quick point here that we really did not get into before. Two-thirds of the banks in the U.S. right now, we rate A or A plus. These are safety and soundness ratings. If we get up the four percent charge-offs, they will still be a quarter to a third of all institutions who are so boring and so routinely mediocre and risk-averse that they will survive. And that is where we rebuild the industry.

Alex J. Pollock: Chris, repeat for the audience your guess on the bank failures over the next couple years.

R. Christopher Whalen: Well, I'm on record with 110 with the fishing trip, right?

Alex J. Pollock: You are way low.

R. Christopher Whalen: I'm low I think, but who knows, we are still nowhere close. But 2009 - a couple hundred. My guess from our screens - we use the FDIC public data - we probably have a couple hundred banks, maybe 400 in the queue. And the FDIC likes to do these a couple a week. They do not want to do one day; Tuesday, Wednesday - that is bad. They want resolutions on Thursday and Friday. So if they can manage it that way, that is what they will do.

Joshua Rosner: And we will skew those numbers by open market saves which will become preferable to closing.

R. Christopher Whalen: Exactly, and [audio glitch] resolution.

Alex J. Pollock: All right, next question right here.

Stephen Kane: Chris Whalen has talked about collateral --

Alex J. Pollock: Could you give us your name and affiliation please.

Stephen Kane: Stephen Kane [phonetic], looking for work. This is on a theme of Chris Whalen about collateralization in the system and also on the Fed and trying to keep them out of supervision. What do you think about issuing Treasury securities that will expire in one day, two days and doing away with bank reserves? That way, the payment system is fully collateralized and it would be good funds. It would be short-duration U.S. treasuries.

Alex J. Pollock: Is that a question to Chris? Or to --

R. Christopher Whalen: Walker.

Alex J. Pollock: Walker.

Walker F. Todd: Yes, I'm supposed to be the Fed accounting guy here. It depends on whether your target is reserves prior to the recent nonsense or reserves now. The historic reserve levels may be 40 billion, \$50 billion in the system. We are looking at reserves like \$900 billion right now. And so which is it that you want to collateralize? If you had to do something to deal with the 900 billion, then you are right. Short-term Treasury securities might be the way to go, but the historic number was small enough so that you do not have to go there, I think.

Alex J. Pollock: Thanks, Walker. Question right here. And then I see somebody waving in the background. I would get to you next. Hang on. Right up here first.

Male Voice: [Indiscernible], freelance correspondent. All make a very wonderful speech, but most important is that, Chris, one word is courage. And I would like to know is that personal courage or national courage to deal with two problems? First is this: Barry talked about the black hole, and I have been seeing that but I'm too small to put this on paper. And if you will read now the Obama bailout package, there are what, 647 pages. Although he said that 825 billion, but in total end it would be one trillion. And really, this is business as usual. If you will read today's Wall Street Journal editorial -- and you understand since time so I do not want to say it, but actually, this business is unusual, in particular, black hole. He goes into one of the so-called homeowner to keep the home, and black hole was bigger. So Obama is a very powerful man and how to change this attitude. And --

Alex J. Pollock: I'm going to have to call you on time here.

Male Voice: Tim said about restructure bank, as restructure bank is very important and very critical, and so I'm saying this, is that courage to do the restructure bank and also to do something against Obama thinking? Thank you.

Alex J. Pollock: Thank you. Anybody who want to take?

Barry L. Ritzholtz: I'll give the short answer is no. The longer answer is a Winston Churchill quote, which is, "You could always count on the Americans to do the right thing after they have exhausted all other possibilities." And we are working our way towards that. We will throw a lot of stuff up against the wall - most of them would not work - and eventually stumbling around drunk in the dark will happen upon a solution, most of which has been discussed up here.

Alex J. Pollock: I had a question far at the back here.

Pat Fitzgerald: Hi, Pat Fitzgerald from Dow Jones. I would like to ask you about the changes of the bankruptcy law and systemic risk. There is an exemption of derivatives from the bankruptcy code, and that was supposed to reduce systemic risk. And it does

not appear to have done that, given what happened in Lehman Brothers. Would anyone care to comment on that?

Alex J. Pollock: We will try that. Chris.

Walker Tood: I would too [indiscernible].

R. Christopher Whalen: Well, Lehman is a model for how you fix this because you will notice that the trustee in the Lehman bankruptcy cancelled all of the credit default swaps. It is a model for how you will eventually have to deal with the over-the-counter derivative positions of the top three banks, which I think is inevitable, by the way. If you look at the loss rate, estimates we have for Citi and then you look at where Ken Lewis is now for BA - next in line - I do not see how else we are going to deal with it.

And to the earlier question by this gentleman, the numbers are going to force us to change our policies because when we rip through that tier-one equity at Citi and it is all gone and everybody looks at one another and say, "Gee, what do we do now?" We still have our preferred, duh, that should have been common in the first place. It is common. In fact, the bond holders of Citi are the owners. The question is, have they figured it out yet?

Male Voice: But is there a --

Alex J. Pollock: Hang on. I'm going to get Walker's short comment, and then we have a lot more questions yet to go.

Walker F. Todd: Right. The bankruptcy exemption, by the way, that has been rolled forward in all subsequent major acts. Here are 25 pages in the TARP bill about putting swaps ahead of everybody else in the event of any liquidations. It is nonsense. I want Washington to stop that immediately. The problem is you are putting the derivative instruments at the front of the creditor line in bankruptcy without correspondingly doing the appropriate level of surveillance. In 1993, the Fed of New York disbanded its primary dealer surveillance unit. That is nuts.

Alex J. Pollock: Maybe we will stop on that line. Next question. Here. Yes, right here.

Male Voice: Ken [indiscernible] of FDIC. I want to know whether you think that the way bank executives and bank employees are being compensated had anything to do with the problem we are seeing.

Barry L. Ritholtz: Of course, absolutely. There had been a complete misalignment of short-term compensation with shareholder interest, with societal interest. And if you are basically paying somebody for bringing assets in or bringing risk on to the balance sheet but not judging them based on how that risk performs, you have completely skewed the scenario. It is not just the outside parties that were buying the bad paper. The big five banks that were actually originating this did another division within the bank was buying

it in house, and the people running that were getting paid not on their performance but on the volume of assets they have brought in. So it is basically running a casino regardless of what the payout is on the one-armed bandit. And the payout was horrific, and yet they still got paid exorbitant amounts. There has to be some form of [audio glitch] going forward. I personally am looking forward to the day when all manners of collectible watches, Ferraris, boats show up on eBay that have been grabbed. But it was absolutely misaligned, and that is a big cost of it.

R. Christopher Whalen: But a point: current law provides that. When a bank creates a loss to the FDIC's deposit insurance fund, the FDIC investigates. And if they find that management was complicit in the loss, they oftentimes file a claim against the estate and the managers, and they start an adverse litigation in bankruptcy.

Barry L. Ritholtz: But that is depository, not investment funds. [Cross-talking]

Alex J. Pollock: We are not going to debate further.

Walker F. Todd: But I'm just saying, that is the answer.

Alex J. Pollock: That is enough. But I want to add that some of us remember that up until the 1930s, shareholders of national banks were liable to be assessed in the event of the failure of the bank, but of course, they still failed. All right, another question right here.

Female Voice: Thank you.

Alex J. Pollock: You may take the --

Female Voice: No, we have one over here.

Alex J. Pollock: I want to take this gentleman right here.

Male Voice: Two quick questions - Bill Gross has gone on record recently about [indiscernible] private equity but if buying up a lot of bank-preferred shares for a nickel and for a dime type mentality. Could any of you guys comment on whether or not you think that is a good strategy on the preferred bank shares and some of the risks that then may be posed if the Treasury comes in and just alters the terms, cuts off preferred dividends, trust preferred sub-debt? How do you guys feel about that?

R. Christopher Whalen: It depends. There are banks out there right now, going back to the point on fair value accounting, that are being forced by the FDIC and state regulators to write down performing assets. They charge them off. So there are a lot of banks out there that look worse than they really are. In that case, the preferred might be a very interesting play, but you have a lot of banks that have not come to Jesus yet; their default rates are too low. We are going to hear about them soon. That is the case where I think the preferred is probably impaired. So it is hard to decide, but you have these two

dynamics because I have bank clients who are literally charging off good loans, so to speak. And that is why I think fair value is insane because these are on the held-to-maturity side of the book, guys. These are not in the trading account. These are the examiners saying, "If you have any doubt about Joe, even though he has been paying you for 25 years every month on time, you have to write it down to the collateral value."

Alex J. Pollock: There is a natural cyclical in all of the behaviors around finance. We have time for one more very short question. We have to keep this very short, though.

Female Voice: Thank you. Well, I had seen the FDIC e-mail that the shared national credits on qualities of 2008 was in better condition than it was in the period 2002 to 2004. And actually the broker dealers went to the SEC and got to be able to expand their balance sheets. I do not know if they directly, but the SEC permitted that. So we have actually seen probably, I guess, whose economy for this number of years from 2003 or so until 2007. We had this back and forth at the beginning of 2007. So even at this point, we are well off into the cycle that you could get a bank call report. You could look at the non-performing assets. You could take that percentage and back it against the equity. You can see if you have an insolvent financial institution. It is not that hard to do de facto. So the [cross-talking] --

Alex J. Pollock: So we have to get to a question.

Female Voice: So thank you. So the aider and abettor, I think, is the Fed. I had stumbled on *The Creature from Jekyll Island* by Griffin. Did somebody say that we should get rid of the Fed? Josh had spoken about capital is king. Regulators also think that. What will we look at if we did get rid of the Fed? Let's start that debate right there or let's start --

Alex J. Pollock: There is a big question, and I do not know the answer to that. Anybody who want to try?

R. Christopher Whalen: It is very simple. You take all the Sup and Reg people out of the board of governors in the reserve banks and you put them in a different agency. They are all very competent people. But if you have conflicted people at the top, they are not going to make good decisions no matter how good they are. I worked in Sup and Reg at the Fed in New York. I love those people. I have nothing bad to say about them.

Walker F. Todd: Right. A form of supervision in a lot of places says that there is an independent bank inspection agency that reports to the federal government of whatever country you are dealing with, and that is probably what we have to get to.

Alex J. Pollock: Hang on because we are out of time. I just want to take 10 more seconds on anybody's part who wants to quickly comment on a notion we have not talked about - the ultimate systemic risk regulator, whether it be the super Fed or somebody else. Ten seconds for anybody who wants to take it, good idea, bad idea?

Tim Bitsberger: No such thing as systemic risk.

Barry L. Ritholtz: Everything becomes systemic risk at that point.

Walker F. Todd: Systemic risk is a big bank concept. You are talking about the nine, 10 largest banks in the United States, for example. Back to my abusive-husband example, how many times do you want to allow the Fed to regulate those banks and bring us to the brink of ruin? And that is where we are at. So it has to be somebody else.

Alex J. Pollock: Maybe on that note, let's show our appreciation to the panel for a really stimulating discussion. Thank you all for being with us. I know people are available for informal talk.

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