Maury’s notes for discussion of three books related to the subprime crisis

[1] -Maury’s notes for discussion of three books related to the subprime crisis [with some editing]:

The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash by Charles R. Morris,
The Black Swan: The Impact of the Highly Improbable by Nassim Nicholas Taleb, and
The New Paradigm for Financial Markets: The Credit Crunch of 2008 and What it Means, by George Soros.

Each of the three books provides a different perspective of the subprime crisis. They are not contradictory; rather, they simply look at different aspects of the problem. The first, the Morris book, describes how we got to the problem. It describes the instruments used, the easy money policy, the lack of regulation of markets, and some consequences of the crash.

The second, the Taleb book, focuses on highly improbable events. It focuses on what we do not know, on our learning the wrong things, on how our minds work, and on uncertainty.

The third, the Soros book, while also exploring the origins of the crisis, focuses on the paradigm used to understand the market. The heart of the book is Soros’ reflexivity theory.

The unifying theme that I will explore is the use of a strategic approach to deal with the issues. For the Morris book, the strategies used in public policy were inept in that they did poorly with forecasting outcomes and dealing with risk. For the Taleb book, the strategists did not understand the system well enough to deal with the risks of the Black Swan, the improbable. For the Soros book, the strategists did not understand the system well enough to know the decisions they were making were altering the system.

The subject is highly complex, especially since the problem is one best attacked with an interdisciplinary approach, because it is an interdisciplinary problem. Because this presentation and discussion is limited to one hour, it will focus on the highlights of the books as they relate to the central theme of using a strategic approach.

I am resuming the Seminar on Improving Strategic Decisions on January 20, 2009 with the focus on the subprime crisis. The Seminar will give us eight hours to explore the issues in greater depth than available for this Books and Ideas session.

The Trillion Dollar Meltdown

About the author Chas. R. Morris: See book cover [or check the web – he is a widely published author and former banker]. The book was published early in 2008.

The critical point that I make in essays that I have written over the late 2007 and all of 2008 is also made by Morris in the forward (page xii). The quote is as follows: “the sad truth, however, is that the subprime is just the first big boulder in an avalanche of asset writedowns that will rattle through much of 2008.”

I wrote about it as the destruction of wealth starting with foreclosures that will run for a couple or few years, and advocated stemming the tide of foreclosures in the fall of last year. The first info that I have about the administration’s concern was Sheila Bair’s comments in the spring of 2008. Ms. Bair is head of the FDIC.

This is important because what we will examine in the three books under discussion, and the forthcoming seminar, is the shortcomings of the forecast of outcomes through the current general understanding of the system by most of the closely related academia and closely related political leadership.

So, what we are looking for in the Morris book is an understanding of the destruction of wealth; how did it happen. The paradigm Morris uses focuses on leverage as the vehicle for the mass destruction.

[If you really understand the quote just read, and another quote on the same page, I would remind you of a statement of my money and banking professor made when we were studying a book called *Money, Interest and Prices,* by Patinkin – if you understand the following paragraph {quantity theory of money etc. referring to less restrictive conditions under which the theory holds} then come back for the last week of the semester…we went through the book line by line.]

In order to understand his analysis it is necessary to understand the nature of derivatives. Financial derivatives may be thought of as a form of claim on financial assets, whereas financial assets may be thought of as a claim on real things. A mortgage is a claim on a real thing, a property as security for a debt. A share of stock is a claim on part ownership of a company. Both, as well as bonds are financial assets. If you assemble a group of mortgages, call it a bundle, and sell interests in the mortgages, those interests are derivatives. They are claims against the bundle. If you slice up the interests as priorities of claims, you have what is known as tranches, the French word for slices. If you bundle the tranches, and sell off interests, you have more derivatives.

Leverage is simply the use of borrowed money in order to magnify gains. The down side is that it magnifies losses. The extent of leverage used by some investors was as high as 33:1. That means a decline in value of the derivative of a shade over 3% wipes out the equity. Now it all gets a little more complicated in that the derivatives were rated by rating agencies. The rating agencies are paid by the issuers and compete with each other to get the business.

Some investors wanted insurance against credit losses. Rather than buy what was legally classified as insurance, they bought “credit-default-swaps.” The difference is that insurance is regulated and requires reserves. Credit-default swaps do not.

All of this is to give you a better understanding of one paragraph on the same page referred to earlier (xii). The paragraph is as follows: “Here is a crude gauge of the credit bubble. Not long ago, the sum of all financial assets –stocks, bonds, loans, mortgages, and the like, which are claims on real things –were about equal to global GDP. Now they are approaching four times global GDP. Financial derivatives, a form of claim upon financial assets, now have a notational value of more than ten times global GDP.”

Understanding how all of this happened is quite complex. Morris sets the stage in the first two chapters, with particular attention to philosophical views in national leadership as well as some root causes. The first chapter, “The Death of Liberalism,” focuses on the disasters of the 70’s. The author identifies what he sees as three of a number of primary roots.

The first root is what he calls "Business Embraces Incompetence." The now classic case is the United States automobile industry. The second is what he calls "The Baby Boom." The baby boom added a bulge in demand for educational facilities, the construction of which and provision of services was a financial burden. The boomers entered the work force untrained for productivity increases and reduced the inducements for domestic capital investment. The Vietnam debacle spurred protests by the boomers. These and other factors let to a shift in national policy at the federal level. The third is what he calls "Mismanagement as Political Art." Inflation may have been the worst of the change in administrations from that of Lyndon Johnson to Richard Nixon, or maybe it was the low level of economic growth, or the combination, known as stagflation. The other contender may be the drop in American prestige abroad, under the Carter administration, especially the hostage crisis in Iran. This view of liberalism, a term which is quite ambiguous [see my notes on liberalism- Mauy's Notes on Liberalism, gave way to what he calls "Milton Friedman's 'monetarism."

Discuss quantity theory of money.

Then discuss "free markets" and misconceptions.

This provides a transition to chapter 2, dealing with the shift and what went wrong in deregulation.

The second chapter focuses on [see page xiv]

"The watershed presidential election of 1980 [bringing] ~~brought~~ free-market~~-~~Chicago-school ideology to Washington, and with it financial deregulation and , in the domestic arena, a steady trimming back of the power of centralized government."

The Reagan administration signaled the shift. Although Volker was appointed by Carter in 1979 he was reappointed by Reagan in 1983, and pursued the control of the quantity of money. Short term interest rates skyrocketed and recession ensued. "The Decade of Greed" (1986-1989) was the name for frenzy deals that collapsed. It was only one of the debacles. The other debacle was the S&L collapse. When Bill Clinton became president in 1993 (following George H. W. Bush) the economy was on the move again, but the irrational exuberance led to the high tech bubble.

The complexity continues in the next three chapters, mostly technical. Chapter 3 discusses structured finance. It focuses on derivatives and mathemazation of trading. It discusses a number of debacles, but let's focus on Long-Term Capital management. That was a Black Swan case which we will discuss with the next book. But if we go back to the opening paragraph of the previous chapter, we see that the quants had a problem.

Chapter 4 takes us to what Morris calls the :Greenspan Put." That is the idea that the Fed rescues capital investments by lowering interest rates. Morris discusses the "1998 stock market plunge." [Page 65.] But, he notes that Greenspan focused only on consumer price inflation, Ignoring asset price inflation. Here is a quote from another piece that I am writing (Pluralism and Interdisciplinary Reasoning: Limits on Knowledge and a Strategic Approach to Policy)

"Former chairman of the Federal Reserve Board of Governors, Alan Greenspan, admitted in congressional testimony "I did not forecast a significant decline because we never had a significant decline in prices." He was referring to housing prices; but, that was only part of the testimony that related to the difficulty in forecasting."

Most important for our discussion is what he calls "The Greatest Real Estate Bubble in World History."

Here is my summary as an excerpt from another work in progress (Subprime Crisis Strategic Decision-Making: A Discussion of What Went Wrong and Strategies to Deal With It):

"The Housing Market

"<u>The housing market created a temporary increase in wealth for many homeowners</u>. The easy money policies of 1990s and early in the first decade of the twentieth century fueled consumer spending beyond sustainable levels. That easy money policy lowered to cost of home mortgage financing enabling purchasers to spend more than they otherwise would. It also brought into the market would be renters and speculators. The result while house prices were rising was that equity rose to where there was a belief that wealth had increased. The subprime lending underwriting standards eroded to where an absence of loan qualification requirements led to loans being made that should not by any standard resembling prudence have been made. The purchase of housing was abetted by federal policy encouraging home ownership and the easy financing provided through government sponsored enterprises, Fannie Mae and Freddie Mac.

<u>"The increased wealth help fund consumer spending beyond sustainable levels</u>. Consumer spending grew at a rate greater than personal income. Some of this spending was from refinancing homes that had been owned for some time. Aside from lump sum refinancing equity lines of credit were used. Consumer spending is also influenced by long term income expectations. For many homeowners that is primarily dependent upon salaries or wages. An economic downturn increases unemployment and destroys some incomes making previous levels of spending unsustainable...."

Chapter 5, "A Tsunami of Dollars," discusses The increased trade deficit and the increase in borrowing from foreign lenders. The basic idea is as a nation we have spent ourselves deep in debt, and the concluding sentence, "The days of a universal put to the Federal Reserve are finally over." We should discuss this in the seminar in greater detail.

The last three chapters focuses on the further movement into the crash and ways of getting out.

Our focus is on understanding the system and institutional reform. We can best discuss that after discussing the other two books. They provide some different perspectives, not necessarily contradictory just different.

The next book is *The Black Swan: The Impact of the Highly Improbable* by Nassim Nicholas Taleb.

Nassim Taleb is securities trader that became a best selling author and was serving as the Dean's Professor in the Sciences of Uncertainty at the University of Massachusetts when the book was published.

In March 2007, according to a Bloomberg report, "Nassim Taleb walked into a conference room at Morgan Stanley's Manhattan offices ...to address a group of the firm's risk managers. His Message: your models don't work." Taleb is quoted as saying, "Past shortfall doesn't predict future shortfall." Six months later Morgan Stanley's troubles surfaced. It wrote down its subprime holdings by $9.4 billion.

It helps to understand how econometric models are constructed, and the concept of outliers. Also, that social science is built upon inductive reasoning. All of that helps to understand improbable events – the thrust of the book.

Let us start with the two opening paragraphs from the book jacket. [INSERT not provided here]

The prologue discusses three characteristics of Black Swans. One is that they are an outlier. The second is that they have a big impact. He third is that we concoct explanations after the fact that would make it predictable.

The name black swan has a history based on deductive reasoning from having seen only white swans

Then black swans were seen in Australia.

The thrust of the discussion is to note that social scientists operate "under the false belief that their tools could measure uncertainty." Although I did not see anywhere in the book that he made a clear distinction between uncertainty and risk, it appeared to me that he deals with risk as measurable phenomenon, but notes that the outliers are treated as nonexistent. Uncertainty is not measurable. Thus, the possibility of Black Swans is overlooked.

At this point a repetition of something mentioned earlier is warranted. It is as follows:

"Former chairman of the Federal Reserve Board of Governors, Alan Greenspan, admitted in congressional testimony 'I did not forecast a significant decline because we never had a significant decline in prices." He was referring to housing prices; but, that was only part of the testimony that related to the difficulty in forecasting."

In the prologue, page xix, under the side heading "What You Do Not Know, he wrote, "Black Swan logic makes *what you don't know* far more relevant what you do know. He discusses the terrorist attach of 9/11/01. If it had been known in advance "...fighter planes would have circled the sky above the twin towers…if your enemy knows…what you know can be truly inconsequential."

He discusses this as a matter of a strategic game – a point relevant to our forthcoming seminar on the subprime crisis. He also discusses natural disasters (the Pacific tsunami of December 2004), and the course of history. He also discusses "…an excessive focus on what we do know; we tend to learn the precise, not the general. My comment on more and more about less and less…[some academics know more and more about less and les until they know everything about nothing].

Although the book is about uncertainty, his focus is sharper than simply not knowing. It includes thinking that one knows. He uses the word "Platonicity" to refer to "mistaking the map for the territory. Plato used the idea of "forms" such as a triangle which is an abstraction. It may make us think we understand more than we do. When we move from the model to the reality, there may be a gap. You can get a Black Swan out of that gap. [Back to the Morris book, page 19]

Just before the conclusion of the prologue in which id discusses format, he makes the following points; It's not just the bell curve, or that the scholars that fool themselves in to believing that they really know,

we lack imagination and "repress it in others." He believes that "..our world is dominated by the extreme, the unknown, and the very improbable…and we spend our time ..focusing on the known, and the repeated, he sees the future as increasingly less predicable , and we should start by focusing on dealing with extreme events. That sounds like a lead in to our discussion of strategy in the seminar,

But here are some quotes from the body of the book===Pages 27,,32,35,28,44,47,54,89,109,120,133,135,140,152,,155, 158

Now for the Soros book,

The New Paradigm for Financial Markets: The Credit Crunch of 2008 and What it Means.

It is one of a number of books by the legendary financier that has made a lot of money. He writes "this is the worst crisis since the Great Depression."I say this will go down in history as the Great Recession.

Soros discuses how it started and the implications, but our focus is on the prevailing paradigm for financial markets. It is generally believed that "…markets tend toward equilibrium and deviations from it are random… both false and misleading." He argues .."and only by exploring a new conceptual framework for how markets really work can we avoid disaster and economic ruin.

The thrust of all of this is understanding the system. His thrust is his theory of reflexivity. "And the current financial crisis can be directly attributed to a false interpretation of how financial markets function."[2] That quotation from the new book by George Soros, *The New Paradigm for Financial Markets,* states the basic premise from which we are proceeding. That succinct statement supports what I have been expounding on in the essays relating to the subprime crisis; namely, we are in this mess because we do not have good forecasts of outcomes.[3] As you can see that is what I have been working on.

Now, for some items from his book. Let's start with the first four paragraphs of the introduction. READ, note relationship between thinking and reality.

The first part of the book is devoted to explaining reflexivity. We try to understand our world, - cognitive function [noted in paragraphs read]

We try to make an impact so as to change what is, manipulative function. Both operating at the same time interfere with each other. The implication is in two sentences as follows (page 4)

The past may be uniquely determined, but the future is contingent on the participants' decisions. Consequently, the participants cannot base their decisions on knowledge because they have to deal not only with present and past facts but also with contingencies concerning the future."

On page 5 he writes "Reflexive situations are characterized by a *lack of correspondence* between the participants' views and the actual state of affairs." He sees the standard economic paradigm as excluding reflexivity, especially in treating supply and demand as independent of each other. He contends that rational expectation theory “totally misinterprets how financial markets operate.”[Page 5]

He also contends that “…social events have a different structure from natural phenomena.”

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[1] -The first book was discussed at Books and Ideas at ASPEC on January 6, 2009. The next two are scheduled for the regular sessions of the Seminar on Subprime Crisis Decision-Making which starts January 20, 2009, also at ASPEC (Academy of Senior Professionals at Eckerd College).

[2] -Soros, page 50.

[3] -The following is a quote from my first essay in the subprime series "Don't Panic Yet: A Strategy for Dealing with the Risk of the Emergence of a Housing Bubble Resulting from the Interdependence of Space and Capital Markets (written preparatory to the research roundtable held October 25, 2007 and published in the Fall 2007 newsletter);

“The role played by the mortgage market is centered on the rise and fall of subprime mortgages including the innovative packaging and distribution of the assets in the form of sliced and diced risk positions. The impact of the subprime mortgages was exacerbated by hedge fund investing with the use of leverage. The quant jocks that develop the sophisticated econometric models to forecast market behavior do a fine job when the structures are unchanged. When the relationships stay the same the outcomes are predictable. But, when relationships charge because of structural innovations the outcomes are less predictable. That was the story in 1998 when Long-Term Capital Management got into trouble and there was a massive rescue operation.

“The current debacle is not only attributable to sophisticated investors making errors, and to rating agencies underrating risks, but to naïve borrowers, some greedy, but others just hoping for better housing. The story of subprime mortgages is the story of mortgages that started out subprime but became “junk mortgages” as the counterpart to junk bonds. The euphemism of subprime obfuscates the reality of exceptionally high risk that would probably not be taken by a lender that intends to hold the mortgage for a long term investment. The issue may be seen as a mismatch of who bears the risk and who reaps rewards beyond risks taken.”