Housing, dot-com bubbles show need for attitude change on risk

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SAN JOSE, Calif. -- The collapse of the housing bubble and the meltdown of our financial system point to a long list of lessons we apparently failed to learn from the dot-com bubble.

But chief among them is how our economy and our culture handles risk.

Risk looms large in the mythology of Silicon Valley. There's nothing we love more than an inventor or an investor who places a daring bet that pays off big. It's what makes this among the most thrilling places to live.

And it is also in our interests to promote risk taking. Without it, innovation and progress would suffer.

And with big risks come big rewards. This is how we've justified the enormous pay packages and IPO riches that flow to those who had the foresight to take the big risk that creates an Intel, an eBay, a Google.

For real risk to exist, though, there must be some consequence to failure. It doesn't have to be extremely punitive. But it has to be there in some form. And not just for a company or organization, but for the individuals who make the decisions.

If you eliminate consequences, then what you get isn't risk. It's recklessness.

That's what we saw toward the end of the '90s. And as I watch the debate over this massive bailout, I worry that once again, we're failing to address this essential issue.

As with the current housing meltdown, investment banks played a central role in enabling the dot-com era. Back then, they created an elaborate system of research and underwriting -- all of it apparently legal at the time -- that catapulted far too many start-ups into the public markets.

Most of these companies were dogs. After the fireworks of a big first day of trading, their stock was more often than not underwater just a few months later. But by then, investment banks had collected their fees, and they had enriched selected clients by allowing them to invest in pre-IPO companies and sell the stock on the opening day of trading for near-guaranteed profits.

After it all collapsed, there was lots of saber-rattling. Inquiries by regulators. Congressional hearings. Shareholder lawsuits. Some personal reputations took a hit. There were new regulations in the form of Sarbanes-Oxley.

But for those who had already cashed out, it amounted to little more than a slap on the wrist.

In other words, there were no consequences for this system-wide failure. Individuals who had made big bonuses selling lousy IPOs got to keep them. Riches from those IPOs stayed in the pockets of founders even if their companies turned out to be complete disasters. While there was no taxpayer bailout, you and I paid for it either through big losses in the stock market or when we suffered in the struggling economy that followed the dot-com bust.

Even as the dust was settling on the dot-com collapse, the housing bubble was inflating. It's hard to argue that people running the institutions at the heart of this debacle didn't know exactly what was going on.

Especially not in the later stages when they were investing in mortgages that were doled out to people based on little or no financial information.

For awhile, these risky bets generated huge profits on Wall Street, which in turn led to record bonuses. According to a Bloomberg analysis, the five largest investment banks on Wall Street -- Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers Holdings and Bear Stearns -- paid $36 billion in bonuses in 2006.
Now the man who previously ran Goldman Sachs, Treasury Secretary Henry Paulson, is asking for $700 billion to bail out his former industry. But over the weekend, Paulson insisted that there should not be a link between executive pay and the bailout.

"If we design it so it's punitive and so institutions aren't going to participate, this won't work the way we need it to work," Paulson said.

Wrong. There need to be severe consequences. And those consequences need to apply to individuals who sit at the top of these institutions. I'm not talking about jail here. I'm guessing that given the degree of deregulation in recent years, most everything that occurred was legal.

But it's both necessary and appropriate that executives who led companies that seek federal bailout money be forced to forfeit bonuses they earned during the periods when they took on these risky bets. And it's even more important that these companies agree to a cap on executive pay, at least until taxpayers recoup whatever money we lend out. Remember, the government required such a cap on executive pay after bailing out the airlines following 9-11.

This isn't just about seeking vengeance or retribution. It's about making sure we strike the right balance between encouraging thoughtful risk-taking and restraining reckless gambling with other people's money.

That's our best hope for stopping the next bubble before it starts.

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Aftershocks; Calling Out the Culprits Who Caused the Crisis


Looking for someone to blame for the shambles in U.S. financial markets? As someone who owns both an investment bank and commercial banks, and also runs a hedge fund, I have sat front and center and watched as this mess unfolded. And in my view, there's no need to look beyond Wall Street -- and the halls of power in Washington. The former has created the nightmare by chasing obscene profits, and the latter have allowed it to spread by not practicing the oversight that is the federal government's responsibility.

I find it hard to stomach the fact that investment banks that caused this financial crisis immediately ran to the government asking for assistance, which Bear Stearns received and Lehman Brothers, thankfully, did not. This is one of many eerie parallels that the current meltdown bears to the Great Depression, when Washington and the taxpayers had to step up and take unprecedented action to stabilize the financial markets and the economy.

Unfortunately, the government today has already put enormous taxpayer resources at risk -- bailing out investment firm Bear Stearns, mortgage giants Fannie Mae and Freddie Mac and insurer AIG, and proposing to buy risky assets from the banking system -- to stop the economy from plummeting into another depression. But these events only underscore the toxic relationship between Washington and Wall Street that has brought us to this point.

To understand the role of that relationship in our current troubles, let's go back to 1999. That was when the hype about the Internet reached its pinnacle. Technology spending by the government and corporations was booming as
both sought to address economic and security fears surrounding the so-called Y2K problem, a potential massive computer shutdown at the start of the year 2000.

In the run-up to the millennium, the Federal Reserve, led by then-Chairman Alan Greenspan, began to pump money into the capital markets to deal with any financial problems that might arise from a Y2K meltdown. In the end, 2000 arrived to nothing but a wonderful celebration. But the monetary stimulus, coupled with the aforementioned hype, created an unfortunate bubble in Internet, technology and telecommunications stocks.

At the center of this bubble were the large Wall Street investment banks, which understood the profit potential in promoting the technology boom to overeager clients looking for the investment of a lifetime. From mid-1999 to mid-2000, Wall Street firms took approximately 500 companies public, raising a total of nearly $77 billion for these companies through initial public offerings, or IPOs. For every IPO, the investment banks themselves earned an underwriting fee of 6 percent, returning them an enormous profit.

But apparently that was not enough for Wall Street. As the middlemen between the insatiable investor demand for anything technology-related and young tech entrepreneurs needing to raise capital, the investment banks demanded the opportunity to invest in these companies before the public offerings, when the company's stocks were valued at a fraction of what they would bring post-IPO. It wasn't uncommon for Wall Street firms to invest tens of millions of dollars in "anything.com" before taking it public, charge a multimillion-dollar fee for the public offering and then watch their investment multiply within a matter of months.

Main Street investors, meanwhile, did not realize that the investment banks had essentially thrown away their underwriting guidelines, which had been in place since the Depression, to take companies public. Among these guidelines were rules requiring that a company be in business for more than five years, be profitable for two or three consecutive years and have certain levels of revenue and profitability. The business models of many of the companies that went public simply weren't viable. Once the Internet bubble burst and the dust settled, America's corporate landscape was littered with bankruptcies and mass layoffs, and investor losses have been estimated at more than $1 trillion.

In an effort to offset the economic strain from these losses, the Fed once again rapidly increased the money supply and slashed short-term interest rates to 1 percent -- a level that hadn't been seen in more than 45 years. This enormous monetary stimulus (along with significant federal spending) energized the overall economy, but it also led to the greatest housing boom -- and possible bust -- this country has ever encountered. From 2002 to 2006, housing values appreciated at an astounding rate of 16 percent per year. It became impossible for the typical American family to buy an average-priced house using a conventional 30-year fixed-rate mortgage. Wall Street found another perfect opportunity to propel and take advantage of another forming bubble.

The result was the explosion of toxic new mortgage products that enticed homebuyers into supporting escalating housing prices while eliminating the need for the traditional 20 percent down payment. Whether it was interest-only loans, low- or no-doc "liar loans," or piggyback home-equity loans, the mortgage and banking industries found a way to place almost anyone with -- or even without -- a credit score into a home. Wall Street played its part by packaging those mortgages into complex financial products and selling them to other investors, many of whom had no idea of what they were buying or the associated risks.

Once again, the investment banks raked in billions of dollars in fees, giving them incentive to keep lowering underwriting standards, allowing mortgage companies to originate and sell even the most unscrupulous home loans, which Wall Street then dumped onto the investment community. Wall Street never once questioned the ethics of these activities; it too was focused on the enormous rewards that allowed its firms to pay out an unfathomable $62 billion in bonuses in 2006 alone. Without Wall Street, the housing bubble would have ended shortly after the Fed started to raise interest rates in 2004, because no lenders would have originated these toxic mortgages if they had to keep the loans on their own balance sheets.

The price of all this greed? Sadly, because of the actions of the investment banks, the mortgage industry and the rating agencies, the investment community has now incurred an estimated $1 trillion and more in losses. Even more troubling, housing prices have dropped 20 percent from their July 2006 highs, with the very real likelihood
that housing could contract another 15 to 20 percent -- essentially wiping out more than $4 trillion in housing
values. This would be the biggest hit since the Depression to Americans' most important asset.

What is even more remarkable is that at the same time, firms such as Goldman Sachs and Lehman not only made
billions of dollars packaging and selling these toxic loans, they also wagered with their own capital that the values
of these investments would decline, further raising their profits. If any other industries engaged in such knowingly
unscrupulous activities, there would be an immediate federal investigation.

Why is Washington so complicit in this intricate and lucrative affair? First, the Fed laid the groundwork for both
these asset bubbles by lowering interest rates to historic lows. In an attempt to protect his legacy after the Internet-
bubble collapse, Greenspan provided unprecedented stimulus to re-inflate the economy and maintain his
popularity with Wall Street. (Remember the "Greenspan put"?) But in doing so, he spawned the largest debt and
asset bubble in U.S. history.

At the same time, federal regulatory agencies such as the SEC stood idly by as Wall Street took advantage of the
investment public during both the Internet and the housing bubbles. The SEC took almost no action against Wall
Street after the dot-com implosion. And in the midst of the housing bubble, in 2006, only the Office of the
Comptroller of the Currency pushed for any level of regulation to address subprime lending.

One has to wonder why Treasury secretaries under Presidents Clinton and Bush -- Robert Rubin and Hank
Paulson, respectively -- took no action to curb these abuses. It certainly was not because they did not understand
Wall Street's practices -- both are former chief executives of Goldman Sachs. And why has Congress been so
silent? The Wall Street investment banking firms, their executives, their families and their political action
committees contribute more to U.S. Senate and House campaigns than any other industry in America. By
sprinkling some of its massive gains into the pockets of our elected officials, Wall Street bought itself protection
from any tough government enforcement.

This is no doubt the same reason why so many members of Congress were consistently blocking attempts to
reform and downsize Fannie Mae and Freddie Mac, which are essentially giant, undercapitalized hedge funds.
These two entities have been huge money machines for Democrats in both the House and the Senate, many of
whom recently had the gall to ask why these companies hadn't been reformed in the past. Nor should several
Republican congressmen and Senators who likewise contributed to watering down legislation aimed at reforming
these institutions be let off the hook.

Wall Street's actions are now profoundly hurting American families, communities and the entire U.S. financial
system. People are being thrown out of their homes. Once seemingly indestructible financial entities are
succumbing to the crisis they have created and have jeopardized the stability of the global financial system. Isn't it
ironic that the same firms that preached free-market capitalism are now the ones begging for a taxpayer bailout?
Many investment professionals operating in my world believe, as do I, that we are facing the greatest financial
crisis since 1929.

Fortunately, today we have safety nets, such as federal deposit insurance, that were non-existent during the Great
Depression. Yet there has not been a time since the 1920s when Wall Street has enjoyed as much influence over
Washington as it has for the last 12 years. Let's hope that this influence fades rapidly -- and that this financial
crisis doesn't end the same way as the one of nearly 80 years ago.

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