$700 Billion Bailout Wastes $7,000 for Each American Family

SAN DIEGO, September 26 – by Chet Billingsley

PART I – HOMES: Starting in 1995, rules were changed and federal agencies were encouraged to loan to not only the rich, and financially qualified, but also to everyone else. Since not much economic support was required for a loan, LTV ratios for many borrowers were allowed to climb to 98% or even 105%. The easy credit resulted in grand homes with equity tapped for cars, toys and a nice lifestyle for many. A recent downward shift in the perceived value we place on having a big home relative to gas, bread and savings caused the price we assigned a typical house, that had bubbled up 100%, to now lose 20% of its inflated value. The unqualified and over-leveraged slipped into trouble.

To alleviate the tax pain felt by the those who got themselves in over their head, a well intentioned Congress eliminated the tax on the gain that people used to have to recognize when they walked away from a loan. Just as the government made it easy to run up a big loan, they now made it easy to step away from that loan. As a result, 6.5% of home loans are now in default.

At the housing level, what then happens is a transfer of wealth. Frugal renters will become happy future buyers, and historically imprudent and aggressive buyers will become future renters. It is a zero-sum game, with the bad for some being good for others. In the end, home prices will have trended down to the new reality, and a greater percentage of the owners of our homes will be those who have been more responsible with their housing investments.

The government bailout upsets this natural balance of reward and punishment in the market. $700 Billion could cover 80% of all defaults and allow the imprudent to stay in their homes (and will make money for us when pigs fly). But, the $700 Billion would have to come from the frugal, who, on average, would be forced by tax to pay $7,000 per family to the wasteful. This reward of waste is not what a great economy is made of. The nation will be better off if the frugal are allowed to keep their $7,000 and use it to buy into their own homes.

PART II – BANKS and WALL STREET: Since the market seems to be working through the foreclosures, why then are we still considering a $700 Billion bailout? The answer here has to do with the influence and size of the big institutions that received these 98% loans and took on additional risks with them. The many imprudent borrowers got their loans from larger imprudent banks, who passed them through Wall Street, and on to rich investors and institutions in America and abroad. Executives and advisors at these banks, investment banks and institutions knew they were taking risk and went for it. “Go big, or go home,” was the motto and much money was made on the way up. 80% or more of investment bank revenue goes right into lavish salaries. To make even more profit (and salary) these firms, like their imprudent homebuyers, took on 96% to 98% debt to fund their business dealings. This was allowed in our system, because the rules had been relaxed to promote fairness in lending to the less qualified. When the market turned, some institutions lost tremendous sums on their previously winning bets.

Having bet the firm and lost everything, these Wall Street institutions do not want to leave the privileged trough where they have enjoyed such great paydays. They argue that they are unique and too big to fail. In their self-importance, they actually believe that only they can provide the financial services they have provided. Their messenger is Treasury Secretary Henry Paulson, the former head and 30 year veteran of Goldman Sachs, who now argues for his former investment banking fellows. In an act of monumental hubris, Paulson asks for Caesar-like power to dole out the $700 Billion to his friends unfettered by courts, laws or review. Perhaps they each should pull their hand out of a bucket of water and contemplate the hole they leave behind.

In reality, better-financed companies with better executive management, will step forward to fill the gap left by the departing investment banks and related firms. Not all firms took great risk. The US Bank president was roundly criticized for not going into sub-prime loans, but his bank is now solid. Sam Zell sold out of his multi-billion dollar REITs at the peak. Berkshire Hathaway has ample cash and now can invest $5 Billion into Goldman Sachs. Leaving the $7,000 per household in the economy for individuals to spend or invest, sometimes in new mortgages, into these replacement firms or other growing companies is substantially better than throwing good money after bad.

Letting losing financial firms be sold off is part of the creative destruction that strengthens our economy. The winners grow and the losers fade away. $700 Billion in funds should not be pulled from the economy and handed to failed firms to prop up risk taking companies and executives at a cost to every other firm and us all.

PART III – THE END OF THE WORLD: Because the reverse Robin Hood plan, of stealing from the poor and giving to the rich, is so hard to sell to financially responsible Americans, Wall Street firms argue Armageddon. If you don't do what they say, the U.S. financial system will suffer dire consequences too terrible to imagine. Since most people are not international economists, how can the average fellow argue? Well, the system just doesn't work as they say.

It happens that a large percentage of the U.S. mortgages were repackaged and passed on to Chinese, Middle-Eastern, and European investors. The argument goes, responsible American families must make up the losses of the Chinese, Arabs and Europeans. If we don't make up for the past losses from overextended borrowers, these foreign investors will no longer lend to the US and we will not be able to get any more credit card, student, housing or business loans. This is impossible.

It is impossible because when Arabs send oil to America, we pay them in dollars. When Chinese send us plastic toys or the Germans send us a Mercedes, we likewise pay them in dollars. They then have two choices: they can buy American goods with those dollars, or invest in American stock and assets. If they go to France with our dollars, the French will ask for Euros. If dollars are exchanged for Euros (or Yen), the exchanged dollars will eventually need to come back to America to buy goods or investment. The flow of dollars is always circular.

Arab oil will continue to flow to the US, Chinese plastics will continue to be shipped, and Nintendo will continue to be sold here. As a result, these dollars will continue to circle back into the US. In the long-run, the balance between imports and exports of goods and services is always balanced by investment. A trade deficit is balanced by an investment surplus. To say the countries will not invest in the USA is tantamount to saying the countries will no longer ship oil, plastics and games to the US. Nobody suggests the supply of goods in the front half of the investment cycle will vanish, so the return of dollars will continue, also.

Additionally, and not to be hard-nosed about it, let us recognize that the foreign country losses are a sunk cost for them. They took a hit. If they invest with us in the future, they can make fresh profits. We do not need to make up for past losses in order them to make future profits. Having lost, they will be cautious. If we pay them more than they were due because much of the bailout flows to them, they will still be cautious. We gain nothing and only transfer hard earned cash from responsible Americans to overreaching foreigners by entering into a $700 Billion bailout that often ends up flowing overseas.

What should then be done is --- absolutely nothing. The government should step back.

Let the market sort things out. Treasury, the Fed and the SEC should only supervise the orderly liquidation of the assets that were squandered and not send another nickel to prop up these institutions. If any much smaller monies should be allocated it should only be sent to firms not involved in the sub-prime losses for the purpose of facilitating substitute avenues for the duplication of the credit functions of the old firms. There will be some tough love disruptions, including a slowing of credit, but these annoyances will be fraction of the pain of taking $7,000 from every American family.

If we take the other path, expanding government's role, we will be transferring wealth from the frugal homeowner to the wastrel, from the well-run firm to the failures, and from Americans to foreigners. We gain nothing from the future foreign investors who will be doubly cautious, in any case. We also set a bad precedent for jumbo loans coming due in the next few years, credit cards, student loans and other dinosaur companies that are or may shift into trouble.

Personally, I would think you would rather keep your $7,000 down payment and cancel the current program and all future installments.

Chet Billingsley is the President of Mentor Capital, Inc. (Symbol: MNTR) that invests in hedge funds and smaller companies. MNTR has no debt and no exposure to the financial, sub-prime or real estate sectors. Information on the firm may be found at www.MentorCapital.com.