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October 20, 2008

An Open Letter to the Treasury Secretary

Mr. Henry J. Paulson:
Secretary of the Treasury
C/o Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Dear Mr. Paulson:

What the (Financial) World Might Look Like in Two Years

In two years, the tribulations of the world's financial system will hopefully be just a distasteful memory.

We may be telling our kids and grandkids about the credit crisis of 2008 and they may think the tale boring. Little they know. Maybe Oliver Stone will do the movie and use his skills to record a fictionalized history of the events-the perfect storm of financial crisis that we have brought upon ourselves. Maybe it will be good enough to keep the scenario from being repeated in successive generations. Let's hope so.

Maybe the world I am about to describe will show up in less than two years; maybe more. Perhaps it won't show up at all.

Here are my thoughts of our world after this crisis is over, the storm clouds have cleared, the sun has returned, and we are wandering around outside our houses wondering what damage we will find and how it's going to get cleaned up. And yes, everyone will find damage, though some may have more than others.

What we have learned and how we all act differently:

I hope this mess is the wake-up call for the baby boomers to finally stop acting like children and grow up. Stop being greedy and build our futures on savings instead of hyped up investment returns (the dot.com bust and this mess being good examples).

Perhaps we will stop listening to the hype about how no one can lose money in real estate, or in the stock market, or maybe we stop buying things that are sold to us (we are the biggest generation for multi-level marketing ever; our parents would not have bought that concept. Well, maybe Ralph Kramden from "The Honeymooners" would have, but that just dates me, doesn't it?)

If we can get the baby boomers to do their homework for a change, then good decisions might get made and our society might get rocked by fewer of the financial storms that blow through when we all chase the same dreams.

Maybe congress will get down to business and realize that what they do up there is actually important to their future, investments and constituency too. I think it's clear that they have just been playing games up there, swimming in a pool of easy money.

I think this because we, as baby boomers, are starting to get old and the thought of going through a mess like this again is more than a little scary.

Maybe we all grow up, or at least enough of us do so that it makes a difference.

I guess there will always be people who want to stay behind in New Orleans when a category 5 hurricane is coming in, but maybe in the future there will be fewer of them because some learned a hard lesson from past experience.

What should we learn? <u>We are each responsible for our own outcomes. We can't rely on snake oil salesmen or some great sales pitch, and then when they don't work we can't rely on a government bailout to save our butts! Like Warren Buffet says, if you don't understand it, don't do it!</u>

Am I asking too much?

Let's talk about who I think needs to be punished for this mess.

Who is to be punished? Who gets to go to jail? We are going to be all about who to punish over the next few years. Let's make up a list of targets, starting at the bottom, and perhaps we will find out who the adversary who to blame is. I have my opinion you are welcome to yours.

First, how about the liars who signed all those mortgages? Those forms have warnings on them about how it is a crime to put down false information and lie when filling them out. Those people need to go to jail. (We had better get a lot of new jails; I wonder if they will have satellite TV?)

Next are the mortgage brokers, who most probably knew or should have known that the people where lying. Should they go to jail too?

How about the owners of the agencies and firms that the mortgage brokers worked for? Some of them make out pretty well; do we put them in prison?

How about the Wall Street firms that packaged up the mortgages and sold the CMOs and CDOs and whole loans to the world? Did they know they were selling liars' loans? Should they go to jail? Oops, many of them are out of business and have lost fortunes.

How about the ratings agencies that blessed those CDOs, CMOs and whole loans with AAA ratings? What do we do about them?

I think, this is where some serious blame is due. If you remember back when Enron failed, the government took down Arthur Anderson CPAs because they had a duty to the public. Although they were paid by Enron to come up with those fancy structures that hid what was really going on, when Arthur Anderson blessed those structures as OK and probably didn't reflect them on the financial statements, it turned out to be a CRIME.

It sounds awfully familiar to me. I think if we send these ratings agencies to jail it should be a Mexican one so they get some sun down there. In my business, we are supposed to be independent and do what is in the best interests of the client. These people, by what I can see, did not. It was everyone else's job to create the product, and then it was the ratings agencies' job to <u>independently</u> determine the value of the "stuff" behind it and the likelihood that the investor would likely get their money back with interest.

Let’s go on:

How about the investors in these mortgages that were sold to them by 150 years old investment banking firms and rated AAA by usually two or more independent rating agencies, were they to blame? Probably, but in my humble opinion, less than most of the others.

But there is more: How about Congress for creating Fannie and Freddie in this strange way where the public took the losses and the stockholders got the gains? How about the same government that created the Community Reinvestment Act (1977), which required banks to make substandard loans, which otherwise they were not prone to do. Yep, in hindsight that looks pretty stupid.

A quick story:

I remember when Enron failed there was an employee, an older women who worked there as a secretary, who got on TV with her 401(k) statement that had a balance of $900,000 or so dollars on it. She was mad as a wet hen because the money was mostly gone. She blamed Enron for her loss. What wasn’t mentioned was that the fraud the boys at Enron put together. (Aren’t we lucky they stayed away from the mortgage business…just imagine!) But back on point- that $900,000 on her statement was only on her statement as a result of the fraud; the account would be worth a whole lot less if the boys at the top had not rigged the whole thing. Just like in this case, a lot of mouths up and down the line got fed, a lot of taxes got paid and a lot of new housing was created by this mess. But back to my story of the future…

So there are a lot of people to blame, probably not you personally, but a LARGE number of individuals were involved in borrowing the money, loaning it out, packaging it up, rating and insuring those investments, and selling and buying them, not to mention the credit default swaps that where bought and sold on these things. (If, Hank, you didn’t see my piece called “The Perfect Storm,” it explains what those are. I know you know, but others who read this letter might not; they can call my office for a copy.)

I believe this mortgage mess went sort of like this:

1977 Banks forced to make substandard loans

2000 dot.com bubble blows up, a lot if investment bankers wonder what to do next

2000+ They discover banks have a lot of this sub-prime stuff on their books and want to get ride of it; the investment bankers remember Michael Milken and what he did with junk bonds (I am not kidding- what's the difference between a junk mortgage and a junk bond?)

2002+ The investment bankers are making money with these loans –and call out for more of them. After all, what can go wrong? The rating agencies join in with AAA/AAA ratings on much of the securities. This makes them easier to sell to foreigners and others.

2005 As the real estate market heats up, everyone gets hungrier, more aggressive assumptions, higher loan to value ratios (Real estate always goes up anyway, right?)

2007 Interest rates start to go up, real estate prices fall and the liars start missing their payments. As we say in skiing, "it's all downhill from here." And so it was.

We will see who our society will blame for all of this. My opinion is clear, and I am not in favor of putting a few million of us in prison; that will only make it harder to serve the bankruptcy papers, the numbers of which, by the way, may be about to blossom.

Our banking structures and how things will look and how we will get there

Maybe it's time to describe what our banking system will be like in a couple of years. You, Mr. Paulson, have already suggested to Congress that perhaps your successor (I beg you to stay on, by the way!) will create a series of perhaps 10 huge mortgage companies that will take the place of Fannie and Freddie. I think that is a wonderful idea; maybe you will work it like this:

Congress (yep, them again) will authorize you to author the creation of 15 entities called Commercial Mortgage Subsidiaries; I will call them CMS's. Each of them will be a subsidiary of a really large institution which will guarantee all of its operations.

The Treasury will loan that CMS a large sum of money at a low rate, but still more than you can borrow it for. That loan will be paid off over 20 years. The CMS will be required to invest those proceeds, and a lot of its own capital that has been put in it by its parent, in what we call now "Qualifying Mortgages" (owner occupied, reasonable credit ratings, 20% down – old fashioned stuff.)

So these new subsidiaries will get cheap loans, that over 20 years get paid back; then they are on their own. They will make a lot of money on that cheap interest rate but so will the taxpayers because we can borrow it cheaper than they are paying for it. The government doesn't take an equity stake in these new deals, as we are not bailing out anyone anymore.

Over the next 20 years as Fannie and Freddie wind down, the new entities can pick up the slack. If the market demands it then the government could provide, for a cost, some private mortgage insurance, or more likely, a private source will do that.

Who would set up these businesses?

Your favorite banks look good to do so:

Citigroup
Wells Fargo (now including Wachovia)
Bank of America (including Merrill Lynch and Countrywide)
J P Morgan Chase (including Bear Sterns and Washington Mutual), isn't Jamie Diamond, brilliant?
Goldman Sachs
Morgan Stanley

Toss in:

Berkshire Hathaway
General Electric
Foreign banks (as long as they play by the rules)

Then some large regional banks could set up some; maybe a little smaller, maybe they could partner up on a few. Maybe sovereign wealth funds, all in all, given the good deal they get from you. I see the big boys all wanting to play this game.

Getting to 15 of them sounds pretty reasonable. And you can set up an auction so that all the mortgages going into them are bid for, once they have been vetted.

Each of those companies would set up a process that checks the mortgage file for compliance, and therefore that mortgage would qualify to be in the package.

There would be modest restrictions about how the capital is used in the CMS's so they must use as I have described above if they want a large, low-interest loan.

And you know what? You could get the FDIC to insure the resulting securities that they issue for a disclosed fee, so the FDIC gets richer. So, when the investors buy a mortgage-backed security they get to choose: FDIC insured at 6.00% or non FDIC insured at 6.375%, with the FDIC getting the difference.

This would give those rating agencies I love so much more time to do their homework on other deals because they don't have to worry about the silly mortgage stuff they didn't understand anyway.

If someone wants a fancy mortgage, an option ARM or a liar loan, great; the banks can issue those all day long but not as part of the above program. This would clean up a lot of stuff, and maybe not remove too much creativity in financing. Some bank somewhere is going to want to do the fancy stuff; let them, but their shareholders are at risk.

Two years from now, we might have a few wonderfully profitable institutions on our hands that will lead us into the next couple of decades of more conservative, less stupid growth and they will pay a lot of taxes to help our government pay its debts. As an investment firm, we have some strong opinions, Mr. Paulson, on what to do in the investment markets for our clients now, but these ideas are only for our clients.

Between now and two years from now I believe we are going to see a lot of turmoil, yelling and screaming, political posturing and without great leadership like yours (not that I like what you had to do anymore that I would like to have open heart surgery.) Without someone with bipartisan leadership skills and with an eye toward saving our butts from falling over a cliff, we will be in trouble.

As I may get too busy writing my new book, Funny Stories to Tell at Your Stockbroker's Funeral and How to Get the Most out of Your Financial Professional During These Hard Times, I may not get a chance to write to you again before your term is up. So thank you for your unbelievably hard work.

I hope and pray that the steps you took are the right ones, in the right direction, at the right time and with enough meat behind them to give us a chance to make changes like I describe above over the next 24 months. I often think that when you took the job as treasury secretary you told your family, "This will be a lot less work (and pay) but also less stressful than running Goldman Sachs. Lots of time at the White House hanging with the celebrities, and maybe we will get to ride on Air Force One a couple of times, and as a bonus, I get to sign the currency. Should be fun, right?" Boy, did you get hosed in this deal! Thanks for doing it anyway.

Sincerely,

Charles Stoll

Charles Stoll

PS: I wrote you a letter about 6 months ago about my idea to solve this housing problem in a way that helps us all. I suggested that you offer a one-time exemption for people who have large amounts of cash or money offshore (illegal untaxed money) and give them a way to get it back in the system, working for all of us, and pay taxes on it. I suggest that these CMS's can issue special debt to attract this money. It would have a zero cost basis so when they sell it one day they will take a capital gain on it. The interest they collect will be subject to taxes. The IRS will not be allowed to use the ownership of these securities as evidence of any wrongdoing. A tax holiday if you will, to get a lot of money back on the tax rolls. I see it as a win-win. I, unfortunately, don't have any millions socked away, but if I did this would be a great opportunity to bring it home or earn interest on it. Also, don't forget to tell everyone that you will change the color of the currency soon; that always gets them going!

PSS: I was teaching my youngest son, Alex, (he says "hi" by they way!) how to drive a car a few days ago, and noticed that he was overcorrecting constantly to stay in his lane. I suggested, and got the chills, because I remember my father giving me the same advice a million years ago, that he look further down the road. focus not on 10 feet in front of the car but 100 feet or more. When he did, the problem went away instantly. I think that is what investors are doing now- they are focused on what is happening this minute, not what a wonderful place this is going to be in a year or two. Perhaps you could mention that in your next speech. Thanks!

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