THE ANATOMY OF A BAILOUT

Chris Bixby, CFP®, EA

Twenty years from now, finance students will be studying the Credit Debacle of 2008 trying to understand what happened, why it happened, and what could have been done to avoid it. Much like the Great Depression, we are seeing a series of events that will drastically change the landscape of the American Economy.

As we are faced with this monumental economic event, we are encouraged to believe that this is somehow new and different and therefore more menacing than anything we've ever faced. If we read Ecclesiastes we know that there is "nothing new under the sun." We also know that God is in control and working all things to his purpose. This is a great relief and encouragement to me. I don't have to worry about the "imminent collapse" of our country. I can rely on a sovereign God!

That being said, we are members of this economy and called to be stewards of what the Lord has given us. How do we interpret these current events and what should we do about them? As I write this article, I run the risk of being labeled as naïve and simplistic. That may be true, but sometimes the most complex problems are best understood in a simplistic light. Some simple observations will give us a framework for processing the "news" we are bombarded with.

I live in Vermont, a small state with one major employer. As IBM goes, so goes the economy of Vermont. Eight years ago, IBM suddenly announced that there would be no more overtime. This was after a period of years of guaranteed overtime for anyone who wanted it. Needless to say, this created quite a bit of havoc in the personal financial lives of IBM'ers. These people had become used to their overtime pay, and their required monthly expenses reflect it.

Within a few weeks of this announcement we began to see boats, RVs, and ATVs for sale by owner. The idea was to sell the boat and get enough cash to make it through the next few months, maybe pay off some debt and generally survive until the overtime came back (which it never did). To make matters worse, other IBM'ers on the same street were trying to sell their boats as well! This created an environment of falling prices on used boats. The kicker was that there were no buyers at all. Everyone was facing the same economic difficulties, and no one was in the market for a boat.

Another option for these IBM'ers would have been to borrow money. The financial institutions would lend them money, if they could show collateral. However, since the boat has a loan on it (the American way!) the boat couldn't be used as collateral. The market value of the boat was less than what was owed.

This is a simplistic example of what we are seeing in today's economy. In the 21st century, banks have three sources of income: debt repayment, investor capital, and sale of assets. As mortgages defaulted (only 2.7%, though) the debt repayment stream slowed down. As real estate prices dropped, the collateral used to attract investor capital was further reduced. As the uncertainty of further defaults permeated the market, the sale of assets stopped completely.

Adding to the problem is "mark-to-market" accounting. While it may sound complex (and in actual implementation, it is) the concept is very simple and commonly understood. Mark-to-market means that the value of an asset is based on the last sale of a comparable product. Essentially this is how our stock portfolios are valued every day. As the "market" for mortgage bonds dried up, the mark-to-market value kept on falling, reducing the collateral banks could use to attract capital as well as the value of assets they could sell. Banks no longer had any money to lend, regardless of their credit worthiness.

Given the importance of credit in our economy, this lack of credit has devastating consequences. So, now the government steps in. Let me say that I am not a fan of government involvement in private enterprise. Having said that, I think that we have reached a point where there is no other choice. If we were to let AIG, Freddie, Fannie, and others fail, the consequences would be so severe that the entire world would face the prospect of entering a significant recession or even a depression.

The government is trying to engineer a plan that will solve several problems at once. In the future, if this works, Henry Paulson will be viewed as one of the true financial geniuses of our time. The government will essentially stand ready to buy assets from companies. This immediately gives companies a value for mark-to-market purposes. This value can be used to attract new investor capital or to sell the asset to the government or another investor. It also gives them current liquidity, allowing them to continue lending.

The concern that many have with this plan is that of moral hazard. Are people learning their lessons? The example of AIG gives us an indication that the US Treasury takes that question very seriously. An $85 billion, two-year, 11% interest loan and 80% ownership interest is a very steep penalty for AIG shareholders to pay. This penalty lending and purchasing by the Treasury will help the economy survive while serving to punish (to some degree) the mistakes and greed of investors, banks and homeowners.

Another concern is the "bad assets" that the Treasury will be buying. We tend to think of these bad assets as the mortgages that are already in default. However, the majority of this debt will be mortgages where the home value is less than that of the mortgage. Many of these of loans are current on their payments and should continue to pay to maturity. The government will purchase these loans at a steep discount, collect the mortgage payments and eventually resell them, ostensibly at a profit.

The backing of the US Treasury attracts investors to the market in general. Investors will be willing to buy Treasury notes to fund the purchase of these "bad assets." The banks will get much-needed cash and shore up their balance sheets. The rest of America, and the world, will have access to the capital required to operate.

Let's not be distracted by the numbers that the media is throwing at us. $700 billion is huge, especially since that might be just the beginning. For us, the size of this number is so mind-boggling that we lose sight of the big picture. Most of that $700 billion is collateralized and will continue to be collectible. As the markets stabilize, the Treasury will sell the assets to pay down the debt and possibly make some money off this debt.

My personal opinion is that, managed correctly, this could be a tremendous boon to the Federal Deficit. Of course, future politicians will probably find a way to spend it all on special interest programs (see, I *am* cynical!). The one thing that we know for sure is that these types of events are recurring. We've seen many markets like this; and if history is any guide, we can expect similar recurrences every three to five years. We will pass laws and regulations to "ensure this never happens again." Then greedy men will find a way around the rules and abuse the system creating a "new" economic failure.

The worst thing that we can do is to take part in the blame game. There is plenty of blame to go around. We can blame this President and the last one, who started the deregulation process. We can blame the Senate who has the most control over the economy. We can blame Alan Greenspan who created the easy access to credit that led to the housing bubble. We can blame the banks, the mortgage brokers, the real estate agents, and the greedy homebuyers.

We should blame ourselves. If you have used a credit card, had a car loan, used a home equity line of credit, or taken out a student loan, you are a contributing factor to the Credit Debacle of 2008. Even though I've used credit wisely, I am a contributor to this event.

What you and I can do is to learn from this mistake. We need to return to living within our means, to follow biblical principles for borrowing and lending, to being content with the financial situations God has put us in. Not all debt is bad debt; the Bible is clear about that. But using debt to live beyond our means shows dissatisfaction with God's provision for us. We are called to be wise as serpents and carefully analyze what's going on in the broader economy. How does this affect the culture? What ministry opportunity does this present? Are there some around us who are needy? How can we adjust our lives to be better stewards of that which God has entrusted us?

This is an exciting time for me personally. I get to reflect to my clients a peace that they don't understand. A peace that comes from knowing, and believing, that God is truly in control of all of today's market events.

Chris Bixby, CFP®, EA

Chris is the cofounder and owner of Bixby & Associates Financial Solutions. He is the firm's principal financial consultant helping clients define their unique financial goals. In 1998 he graduated from Bob Jones University with a degree in Financial Management. After working as a trainee and then an associate for a local Vermont firm, Chris cofounded Bixby & Associates. He holds the NASD Series 7 and 66 securities licenses as well as his insurance licenses.

In 2003 Chris earned multiple professional designations. He was approved to use the CERTIFIED FINANCIAL PLANNER™ designation and earned the Enrolled Agent designation from the IRS. He is currently pursuing a Master of Science in Administration degree from Saint Michael's College in Colchester, Vermont.

Currently Chris is a member for the Vermont Tax Preparers Association as well as serving on the University of Vermont Extension Tax School Advisory Council. He is also instructor for the National Association of Tax Preparers and an adjunct instructor for Champlain College.