So You Don't Like the Wall Street Bonuses...

Don't fall for the populist rage—look at the real causes of the crisis

I love New York City. As a New Yorker who wants to see our commercial real estate market thrive, I know that a strong local economy is an essential element to healthy real estate fundamentals. In order for our local economy to be strong, we need a strong financial services sector, and Wall Street is the keystone to our most dominant industry. As it goes, so goes the city.

The topic of Wall Street bonuses is one which elicits tremendous emotion from U.S. citizens and most of that emotion has been anger. Certainly, we have seen Congress object strenuously to these bonuses and even the president has referred to them as "the height of irresponsibility" and "shameful" and "obscene." He claimed that the Fat Cat bankers were acting in a manner which was "in violation of our fundamental values." The president endorsed a special tax on the big banks because he said, "We want our money back," referring to the TARP money which was invested in the system. After all, "Wall Street caused this mess," according to the White House.

Recently, Mr. Obama has softened his language. Perhaps this was because he realized a populist position against New York's big businesses was not the only thing that he could do to revive his plummeting approval ratings; perhaps it was because bankers pointed out that they were really not the cause of the crisis; or, perhaps, it was because he doesn't want to appear to be as overly anticapitalistic as some of his positions convey.

The anger felt across the nation is palpable and hit home for me when I made a pro-Wall Street bonus comment at a distressed asset conference I was speaking at in Los Angeles recently. I mentioned that the way Wall Street bonuses were being paid, in both amount and nature, was anti-stimulative, particularly relative to the New York City economy. My argument didn't go over well. I have been contemplating whether to write this piece or not for weeks as I know it is not likely to be popular. I do, however, think it is important to look into this issue further, especially given the impact it has on New York City's local economy and on our commercial real estate market.

The first assumption that needs to be challenged is that Wall Street created the financial crisis. There were indeed many market participants with culpability in creating the worst recession since the Great Depression. Bankers were joined by brokers, appraisers, rating agencies, mortgage brokers and other players, all operating under the assumption that housing prices would never go down. This was not as outlandish an assumption as we now think as average home prices in the U.S. had remained fairly steady for decades prior to this recession. But understanding the dynamics of this downturn helps us realize that Wall Street was not the cause.

The first domino to fall, and the main reason that the recession has been so severe, was the government's initiative to increase the homeownership rate in the United States. For decades, a homeownership rate of 62 percent seemed to have been a stable, sustainable rate. In order to increase the rate, it was necessary for the government to exert pressure on Fannie Mae and Freddie Mac to loosen their standards. With governmental direction and significant pressure, the table was set for these government-sponsored enterprises to facilitate people buying houses who could not afford them. At the same time, in the early 2000s, the Federal Reserve kept interest rates too low for too long, another key ingredient in this process. This set the stage for the private sector participants to take advantage of the government's "push homeownership" initiatives. When Congress decided to interfere with the free market, as they thought it would be better for the country to increase the percentage of Americans owning homes, they left a window wide open.

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Another misconception about the crisis is that with proper regulation it would have been averted. Clearly, there were millions of foolish loans made during the housing boom. Some say that banks took advantage of unsuspecting borrowers while others say that borrowers' lies took advantage of banks. Both of these perspectives are probably equally correct. Lender fraud was, however, not the overriding cause of the crisis; therefore, additional regulation would likely not have prevented it.

If we look at the housing meltdown carefully, we see three distinct phases. In the first, Fed Chairman Alan Greenspan kept interest rates too low for too long, which not only inflated the housing asset bubble but created a very steep yield curve where short-term rates were so low that they encouraged adjustable-rate loans. The percentage of floating rate loans ballooned during this period. These mortgages, which had exceptionally attractive rates in the first few years of the loan, attracted speculators and flippers just looking to make a fast buck. Mortgage equity withdrawal hit all-time highs as homes replaced ATM machines as the fastest way for Americans to put cash in their pockets. Loose underwriting standards, precipitated by what Fannie and Freddie were instructed to do, let many people qualify who never should have. These adjustable-rate loans were the first to hit the fan.

In the second phase, the myth that average home prices never fall was shattered. Across the country, values plummeted, leaving nearly one-quarter of homeowners with mortgage balances in excess of the value of their houses. When this happened, owners responded by sending their keys back to the bank. With Fannie and Freddie under pressure to get Americans into homes they owned, mortgages with overly accommodative terms like miniscule downpayments, low initial interest rates or even negative amortization were abundant and the results were devastating. While the S & P / Case-Shiller index showed average prices falling by about 22 percent nationwide, several markets were really battered, including Miami, Las Vegas, Phoenix and many areas of California. In fact, Florida, Nevada, Arizona and California are home to nearly half of all foreclosures nationwide. Not surprisingly, there appears to have been more speculators and flippers in those markets than anywhere else.

In the third phase of the housing crisis, we have seen stress caused by traditional recessionary pressures, particularly unemployment, which, if you are a frequent reader of Concrete Thoughts, you know I believe has a more profound impact on real estate fundamentals than anything else. These pressures have been magnified by the conditions that preceded this phase of the crisis.

When this first domino, the housing market, was toppled, a chain reaction resulted. As early as 2003, stresses in the housing market were apparent and it was clearly having an impact on the GSEs. When looming problems with Fannie and Freddie were brought to Congress' attention, it was Barney Frank who infamously exclaimed, "Let's roll the dice with Fannie and Freddie". The rest of Congress concurred and that decision may lead to over $400 billion in losses before the dust settles.

Given this set of facts, how can the administration credibly say that Wall Street was the sole cause of the problem? The fact is that the government invested in the banking system—it was not "bailed out." The automakers were bailed out, and Fannie and Freddie were bailed out; and we will likely never see a return of our investment in those zombies. TARP funds were extended to save the economy, not just to save the recipients.

Why single out the banks? Because it is politically popular? The banks have repaid most of their TARP money, with about $20 billion of interest to boot. The administration has unfairly vilified the big banks. Who among us would like to be treated the way the government has treated the banks? They were given TARP funds; some reluctantly agreed only after the support was forced upon them. Then, after the fact, compensation was restricted at banks which received the money, and, recently, it has become apparent that each bank has jointly and severally guaranteed repayment of all TARP funds. Who would have knowingly signed up for that?

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And Wall Street is being chastised for making profits. This is amusing as the main reason the Street is making so much money is because of government intervention. And I am not talking about TARP. Two major competitors were allowed to fail before it was decided that some institutions were too big to fail (too big to fail produces many shortcomings and should not be part of a capitalist society, but that is another column for another day). Less competition is a good thing for business. Imagine if two of the large national brokerage companies disappeared. How happy would the survivors be?

Additionally, the Fed's monetary policy is allowing the banking industry to recapitalize as they bo row at rates close to zero and can e ther make loans to achieve massi spreads or simply buy risk-free i struments and make spreads of hu dreds of basis points. The admini tration clearly agrees with this poli as a re-nomination of Fed Chairma Bernanke would not have occurre otherwise. The government is allow ing these profits to be made. Funn that they begrudge them.

The constant bashing of W Street has been particularly punis ing to New York. I am not suggesti that the Street has not done a po job of explaining that their bonus are really not bonuses—they cou have done a better job of explai ing the compensation structure. T Street has historically paid abo 50 percent of revenue in the for of compensation. This year, the pe centages will be well below the hi toric norms. Moreover, much of th bonuses will be paid in restricte stock, which is a second body blo to our local economy and is simp a response to political pressure. T city and state do not collect incom taxes on pay that is not distribute and taxes are not paid immediate on restricted stock. This forgone t revenue, and the resulting decrea in disposable incomes, is devasta ing for New York.

The result for the local econom is that tax revenue will be off by bi lions and billions of dollars, addin to our fiscal difficulties.

Equally important, bonuses pai in restricted stock cannot be spe to buy products. Most of these pro ucts would have been purchase locally. Also, what about all of th jobs that will be lost due to cuts th would need to be made to balan municipal budgets? Even more of to day's precious jobs will be sacrifice as tax revenues fall even lower tha expected. Those additional jobs lo produce an additional drag on o economy.

So, yes, the way Wall Street bo nuses have been paid is anti-stimu lative to our economy. So if you lov New York, consider the consequen es of agreeing with populist ange against our economic engine.

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