Good Debt, Bad Debt and a Better Way Forward

by Steven A. Markowitz

Chapter 1

Introduction – Standing Up to the Bankers

This story is about just one of the many Americans burned by banks and wealth managers during the economic meltdown that began in 2008. Our financial system not only permitted, but helped promote excessive risk-taking by the financial services industry, which had a role in the losses suffered.

In addition, governments and central banks tempted investors into excessive risk-taking through their interventionist policies that included increased monetary liquidity and low interest rates. The macro result was a global financial crisis caused by the drying up of the credit markets. As securities markets of every kind plunged, the number of Americans who suffered vast loss of wealth was huge, but never completely tallied.

But many in the financial services industry had a different outcome. Besides the profits they had obtained by selling high risk paper and facilitating ill-advised mergers, they were rewarded with bailouts, huge injections of liquidity that supported balance sheet recovery, and ultimately regulations that did not materially change the conditions that caused the crisis. The low interest rate policies continued today by central banks are an ongoing form of bailouts allowing banks to profit, in some cases by loaning the same funds back to governments, at higher rates.

Many thousands of individuals lost their life-savings in the crisis. Of these, many suffered from poor financial planning and advice, whether from their bankers or financial advisors. No one bailed out most of these victims.

However, unlike most Americans, I did not accept one of the losses as being an accident or bad luck of the markets. This investor took his financial advisor and banker to court and partially won. But, more important than that individual victory, this investor has a lifetime of experience in healthy finance – the development of a different, conservative philosophy of investment that works without depending on speculative bubbles or the financial services industry.

This book exposes the incompetence, dishonesty and lack of accountability of the financial services industry. It is a story of how a conservative investor who shunned that industry for years got unwittingly sucked into the vortex of “lemming style" investing that characterized the years from 2001-2007.

Having profited from a conservative philosophy for investments for decades, I would have avoided major loss from the 2008 meltdown, had I not been the victim of financial advisors whose supposed expertise in the field led to foolish, high-risk asset placement, incompetent service and ultimately a cover-up.

Although a court found that my advisor acted against my interest and that the advisor “… did a poor job in effectuating its investment decision…”, “… did not diligently attempt to obtain the auction rights for 12 months", and "… was disingenuous", I was only able to recuperate pennies on the dollar for losses on the investments managed by that financial advisor. Our legal system is either incapable of holding, or refuses to hold, the financial industry accountable for its misdeeds.

Speculation Causes a Financial Crisis

The financial crisis of 2007[1] began when, in June of that year, Standard & Poor's and Moody's Investor Services, both responsible for rating the quality of financial instruments, downgraded over 100 bonds that had been backed by second-lien subprime mortgages. This was highlighted in March of that year when international bank HSBC announced that one portfolio of its purchased subprime mortgages' pool evidenced much higher delinquency than had been built into the pricing and rating of these products.

Speculation in "Structured Products"

At issue was the quality of the credit behind the mortgages and ultimately their pooled-collateralized investment securities offered. Greedy bankers, desperate for yield, had provided mortgages to consumers who had little means to pay them. Often, borrowers did not have to provide proof of financial capabilities to obtain the loans.

The bankers who sold these mortgages to consumers then quickly sold them off to larger banks that sliced and diced them into repackage bonds called Collateralized Debt Obligations (CDOs). These CDOs were complex financial products that few understood, including Standard & Poor's and Moody's Investor Services who were responsible for rating the quality of these bonds. Nonetheless, the bonds found willing buyers who were looking for regular income and increased yield. Unfortunately, they turned out to be high risk investments, irrespective of their ratings.

The downgrade of these mortgage-backed bonds sent a shudder through the entire financial system. Banks worldwide had been creating mortgages of this type, wrapping them into collateralized bonds and other kinds of financial instruments, and then selling them with high credit ratings to unsuspecting buyers. Given the breadth of the bond sales, the possibility that these instruments weren't creditworthy put the entire world market for structured securities into a tailspin. Credit of all kinds dried up and the large Wall Street Banks very survival became at risk.

End of Cheap Money for Financing

The drying up of credit was a disaster for any number of financial institutions. There had been cheap credit available for years, based on the choice of the Federal Reserve and other central banks to keep interest rates exceptionally low to gin up the economy. The relatively new structured financial products added to this orgy of cheap credit

In addition, while the very low interest rates maintained for an exceptionally long period had given banks access to cheap money for this extended time, it also cut into their returns for relatively safe investments. In search of higher yields banks lent that money at higher risk to many who could not repay the loans. These risky bonds were then made salable due to the inappropriate bond ratings supplied by the rating agencies.

The banks, which became rich when the risky mortgages were given, were now at risk of failing due to their poor decision to increase their leverage. When the collateralized bonds true risk became known, their sale was no longer possible, which not only put an end to the housing bubble, but also put at risk the survival of the large banks. Leverage has put a stake in the heart of many businesses even during minor economic downturns. With the economic tsunami that hit in 2008, leverage placed at risk the very survival of most major American banks and with them the overall world economy.

Bankers' greed for rewards
With leverage, banks around the world had plunged far more risk capital into these mortgage-backed loans and structured products than they could possibly maintain. With no regulations to stop them, bankers made as many loans and investments as they possibly could during the housing bubble. Each time they were rewarded by fat incentives and profits tied to the completion of these financial products, not the long-term viability of the loans. In addition, bank compensation policies rewarded executives and traders based on short-term gains, irrespective of long-term consequences to their business or greater public.

As a result of these perverted policies, bankers lent far more than they had a right to risk. Some of the overleveraged institutions simply failed, like Bear Sterns and Lehman Brothers. Others, like Citigroup, were rescued by government bailouts or in the case of insurance giant AIG, were nationalized (or nearly nationalized). Other banks who survived the carnage received backdoor bailouts in the form of cheap taxpayer-sponsored loans. The fear of "systemic risk," in which a large bank failure would send the entire global monetary system into chaos, was the justification of the bailouts as those banks were deemed 'too big to fail.'

Politicians Take Over
There were no criminal charges brought against the financial services actors who were behind the speculation. Instead, the government took extensive regulatory actions, theoretically to prevent such a crisis from happening again. This culminated in the Dodd-Frank Act of 2010, which was a vast compendium of regulatory changes intended to gain more control over the banking system. In reality, this act favors larger banks who can better afford its cumbersome regulations.

At this writing, Dodd-Frank is three years old and only about 30 percent of all the regulations it calls for have been implemented by U.S. government agencies. It will likely take a decade before any real effect from Dodd-Frank is felt. Meanwhile, banks have begun trading and speculating again with the lion's share of profit at major banks in 2012 coming from speculative trading activities. [2] Central banks continue with historically low interest rates that pressure banks and individuals to once again take on more risk in search of yield.

Politicians have created lots of new regulatory posts and increased the power of agencies like the Securities and Exchange Commission to send in inspectors, but our financial system remains essentially unchanged. Banks that were too big to fail in 2008 are even bigger today. This makes the likelihood of another crisis requiring additional governmental bailouts significant.

The Victims and their Advisors
Of the thousands of Americans who lost their lifesavings in the crash, many had been given a false sense of security because they worked with a financial advisor. We will discuss later in the book the details of what that really means.

But there is every reason to assume that financial advisors and wealth management firms were just as caught up in the frenzied search for yield as were the bankers. At the same time, since much of this industry's fees are based on a percentage of the assets managed, they directly benefited from the asset bubbles created.

As a Deloitte industry analyst puts it:

"For wealth managers, the period 2004 to 2007 was characterized by ever-higher asset prices and aggressive growth strategies. Throughout these boom times, wealth managers experienced significant growth in the size of assets under management and increasing revenue margins…The global financial crisis, however, triggered a staggering 24 percent drop in profitability.[3]"

Part of the reason for the drop in profitability was the fact that clients had ceased to trust their financial advisors, having suffered losses during the crisis. Advisors had what the industry referred to as an "eat what you kill," attitude to relationships with clients. Nearly 100 percent of major firm's business was commission-based, so advisors could just sell a lot of products and make healthy incomes. Consumers who suffered in the crisis ceased to trust advisors who "ate what they killed," and have since been more likely to seek advisors who earn fees based on specific services. [4]

While the industry has been moving more to fee-based work, financial advisors don't have to use this model. Under current rules, advisors can adhere to either type of business, depending on how clients pay for their services. The commission-based system encourages advisers to steer clients into costlier products that earn them fatter commissions. They may call themselves 'advisors', but they are effectively sales reps.

There is considerable debate, which we will discuss in Chapter 2, about who is an advisor and how advisors should function. But, in my own case and that of many before and during the financial crisis, the financial advisor was more concerned about commissions than about my financial future. Like the bankers who sought rewards for making deals, the advisor placed my funds in an obscure instrument that, once the crisis hit, became illiquid and plunged in value. However, the firm that purchased these investments assured me that there was "no downside risk" to the bonds.

This book will recount my own suffering and eventually how I was able to recuperate at least some of what I lost through litigation. But the book will also place my own story in the context of the whole trouble with the financial services industry, its unwillingness to operate according to the most basic principles of ethical business practices, and the industry's penchant for promoting debt.

The book will also tell the story of how my family and I built a company based on viable business principles and low debt. Fending off the assaults of bankers who, especially during boom years, sought to drag us into the unsustainable debt vortex, we financed growth organically and, in doing so, built new businesses with the funds that we earned.

We will, oppose to the malign and tottering edifices of the financial services industry, proffer the principles of a conservative financial philosophy that actually creates real and long-term value.

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[1] For a summary of the academic view of the crisis, please see "A Bird's-Eye View, The Financial Crisis of 2007–2009:Causes and Remedies," Viral V. Acharya, Thomas Philippon, Matthew Richardson, and Nouriel Roubini, February 2009

[2] "Trading boosts Morgan Stanley earnings," Financial Times, July 18, 2013; "Goldman Sachs and JP Morgan see profits surge in 2012," The Daily Beast, January 16, 2013

[3] "Winning in wealth management," Deloitte 2009

[4] "Younger generation is scarce among financial advisors," Crain's Cleveland Business, April 29, 2013