Housing Rarely Presages A Balance Sheet Crisis But Routinely Leads To Ordinary Recessions. Why We Are Stuck, And What's To Be Done.

Vernon L. Smith

Directors Roundtable

September 23, 2014

Chapman University

Based primarily on

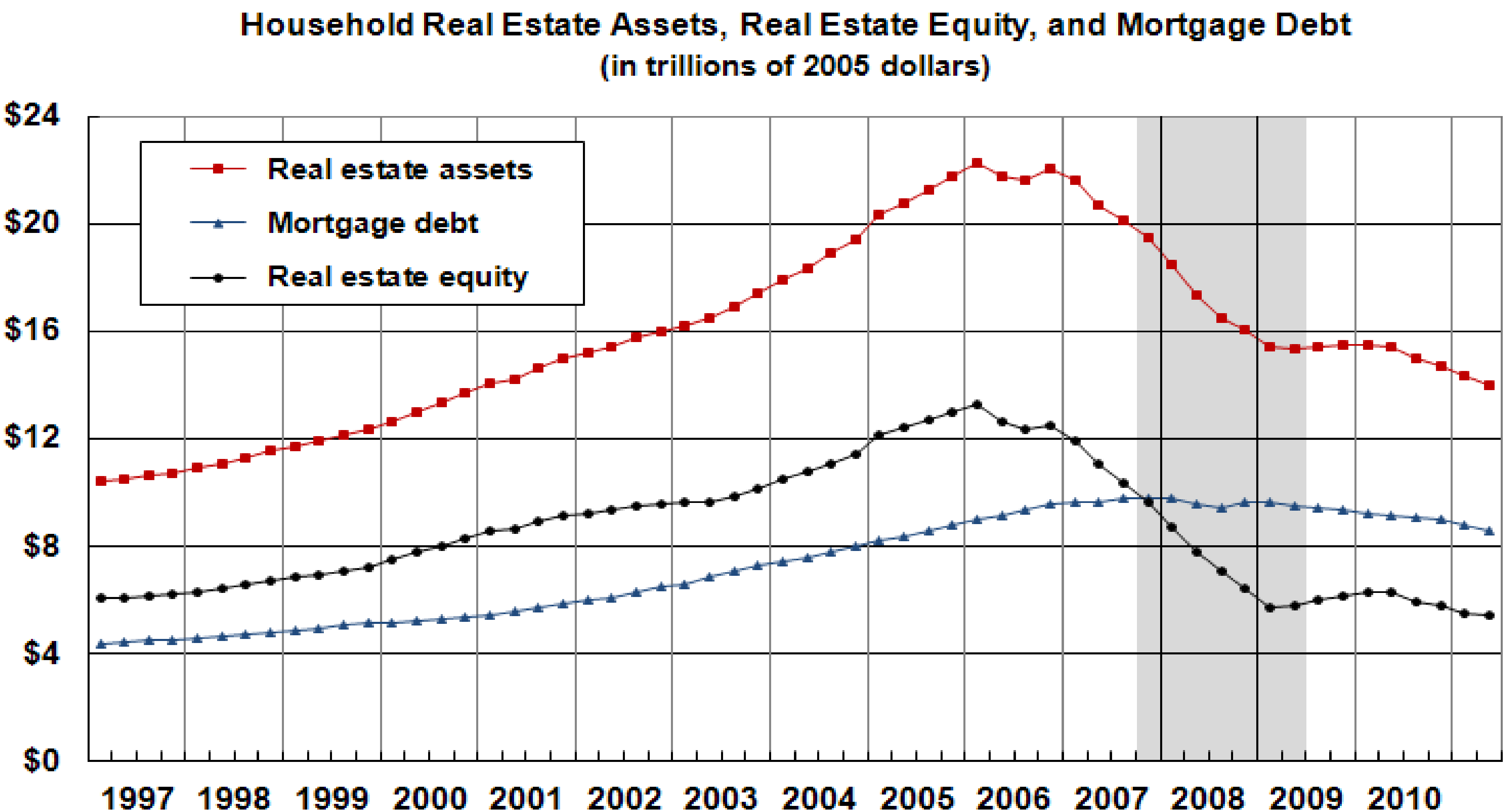
RETHINKING HOUSING BUBBLES,

Cambridge, 2014 by

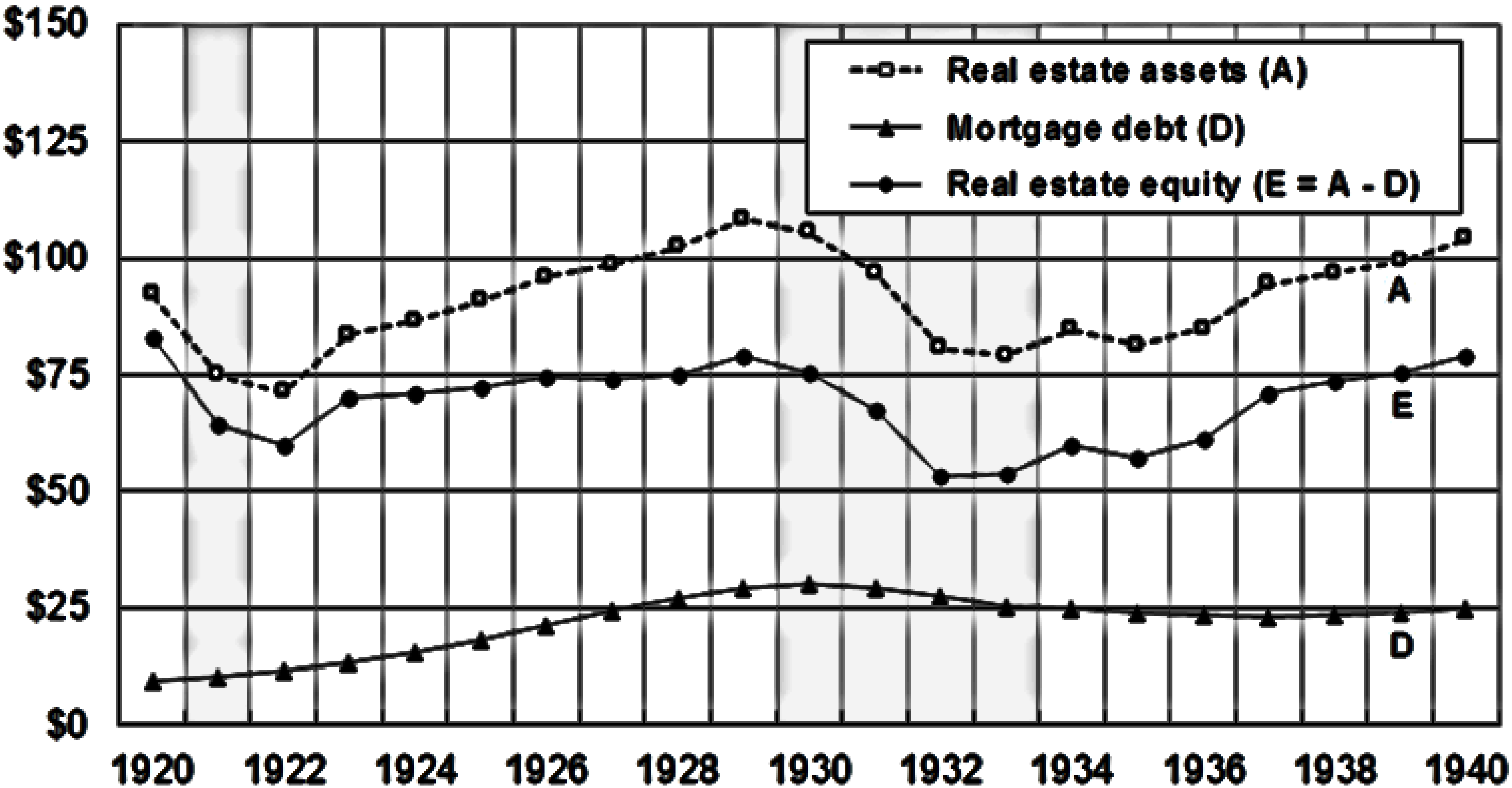
Steven Gjerstad and Vernon L. Smith

Proposition 1:
The Great Recession and Depression Viewed as Household-Bank Balance Sheet Recession Crises

Great Recession: As housing values rise mortgage debt rises in step, bubble-like, 1997-2006. With a drop in housing value mortgage debt remains fixed, declining only after a lag; equity (value minus debt) collapsed 2006-2009.

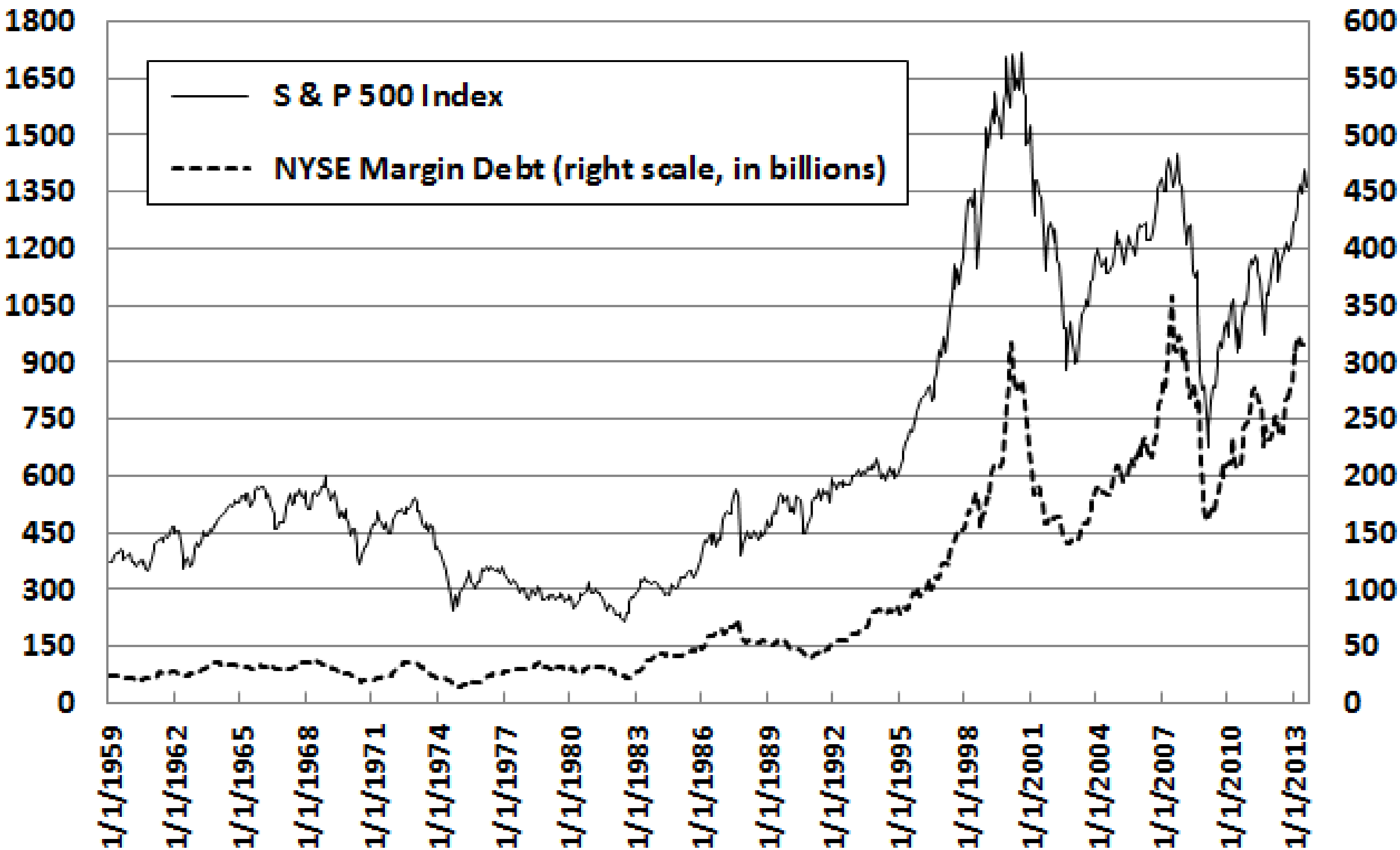


Housing Assets, Mortgage debt and Equity, 1920-1940. Decline in value against fixed debt was large (E:-1/3), less severe than in Great Recession (E:-1/2).



Proposition 2: Why Stock Market Crashes Do Not Cause Enduring Household-Bank Balance Sheet Damage

Margin Debt moves up AND DOWN with stock values; does not damage household-bank equity like housing declines



The Federal Reserve did not understand proposition 2 in 2005:

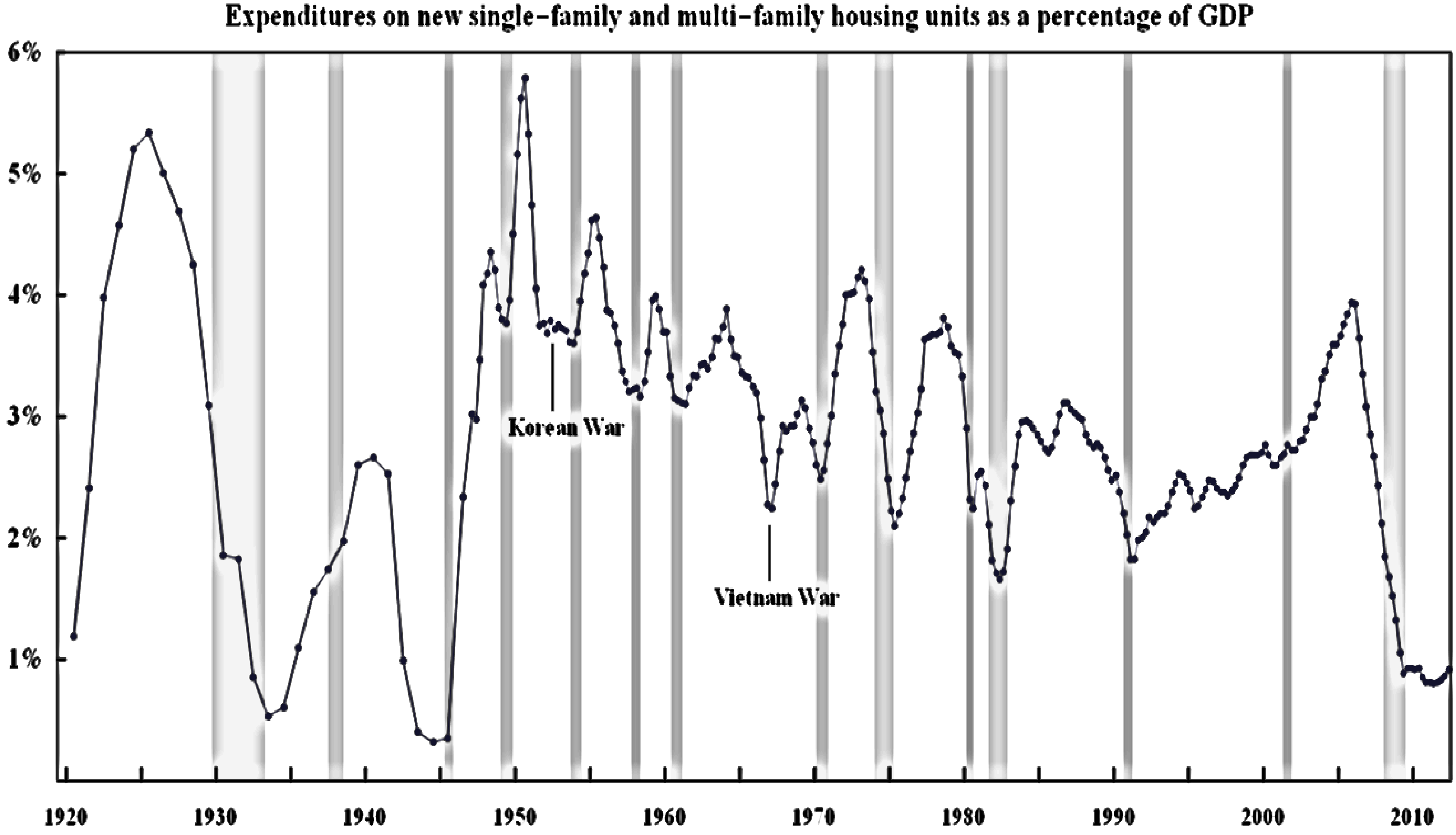
FOMC Conference on the housing bubble, 2005:

The question: Is there a bubble? The answer,

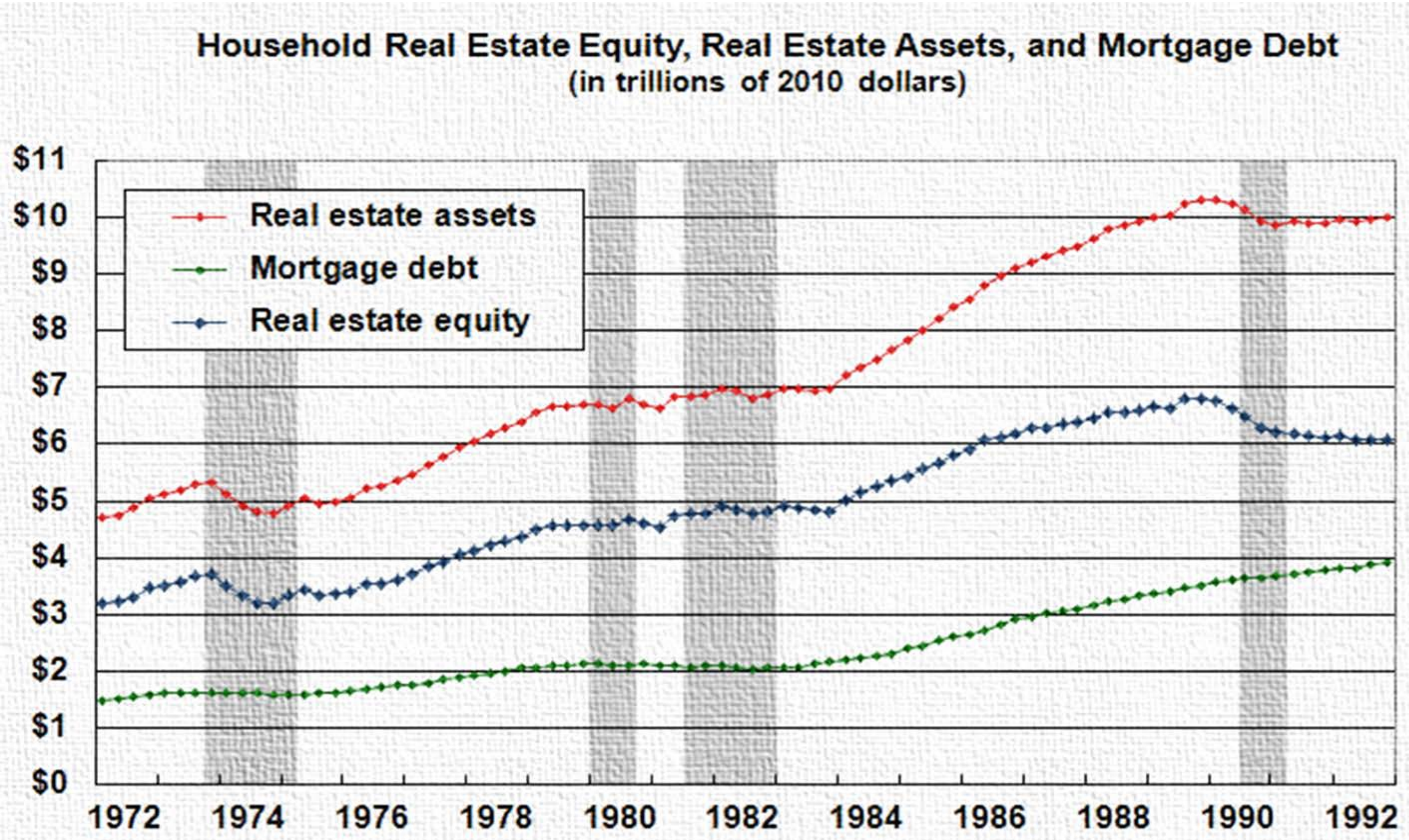
- YES, house prices have risen far in excess of income and rentals. Conclusion: although uncertain
- "…nevertheless, it seems clear the magnitude of the current potential problem is much smaller than, and perhaps only half as large as, that of the stock market bubble (dotcom market crash of 2001-2)." (Williams, 2005, pp. 17-18)

Proposition 3: The Ordinary Business Cycle is the Consumer Housing Cycle and Does Not Damage Balance Sheets

Housing construction, % GDP, since 1920: housing led in 11 of past 14 recessions; all GDP recoveries occur with housing; only Depression, Great Recession, were balance sheet crises.



The Typical Post WWII Recession: No Serious Damage to Household-Bank Balance Sheets



Proposition 4: How To Achieve Escape Momentum From Recessions With Large Numbers Of Damaged Household & Bank Balance Sheets?

Not with monetary expansion; monetary super-ease is inert for reviving a depressed economy; ”pushing on a string.”

Not by government deficit spending; fails for the same reason that monetary ease fails.

Why? Too many low, zero, and negative equity, balance sheets.

WWII spending was not the exception; by 1940 we had experienced 10 years of balance sheet repair; household equity returned to normal levels—home equity = 1929 level—and government spending restored as an effective stimulus.

Proposition 5: Recovery Through Bankruptcy and Default as a Balance Sheet Repair and Reboot Process (Sweden & FDIC)

- **bank mortgages marked to market;**
- **Banks recapitalize through private markets; downsize as required; zero out equity, bond hair cuts as needed; only prepaid insured deposits guaranteed, not investors. (Sweden's banks put through bankruptcy, early 1990s; also Finland; 489 banks failed at FDIC, 2008-2013).**
- **Why does allowing failed banks to fail foster recovery from balance sheet crises? *The return on investment and lending in new economic activity is undiluted by past claimants whose investments failed. Any dilution reduces the demand for new activity.***
- **Removes balance sheet barriers to lending, borrowing, resumption of normal household demand.**

Proposition 6: The Political Process Protects Incumbent Investors From Bankruptcy & Default—U.S. & Japan TBTF.

In U. S.

- **Carry bank mortgages at book value;**
- **Borrower makes full payment, if at all feasible;**
- **if not, lower payments by stretching the loan terms and lowering interest; otherwise foreclose or short sell house.**
- **Bail-out of BAC and C investors; shares sell for 75% of book value; reported profits good (but investors read "profit" as doubtful; compare WFC, shares 175% book).**
- **Recovery stalled; by Depression clock time, 2012 was 1934, when GNP grew 7.7 percent; slump worse then; but have we simply stretching out the years of lost output?**
- **Prediction difficult:** ***U.S. has no experience with massive downturns, bail-out 'cures,' and continued balance sheet damage.***

Japanese Form of TBTF

Japan: House prices peaked, 1990; fell 25 percent, by 1992; by 2004 had fallen 65 percent.

Government response: Allow banks to make "support loans" to distressed borrowers to enable them to continue to make their payments from 1993-2004; Banks did not book these de facto loan losses; stretched write-downs of loan losses (20% of GDP) over 12 years.

Objective: allow Japanese banks to offset their losses on bad assets with earnings from sound assets as those earnings were expected to arrive. But effect was also to dilute return to the financing of new economic activity.

Consequence: Japanese banks suffered from a 15 year decline in lending (minus 1.7% per year)

What is to be done?

The public policy damage from preventing the bankruptcy of failed banks cannot be changed.

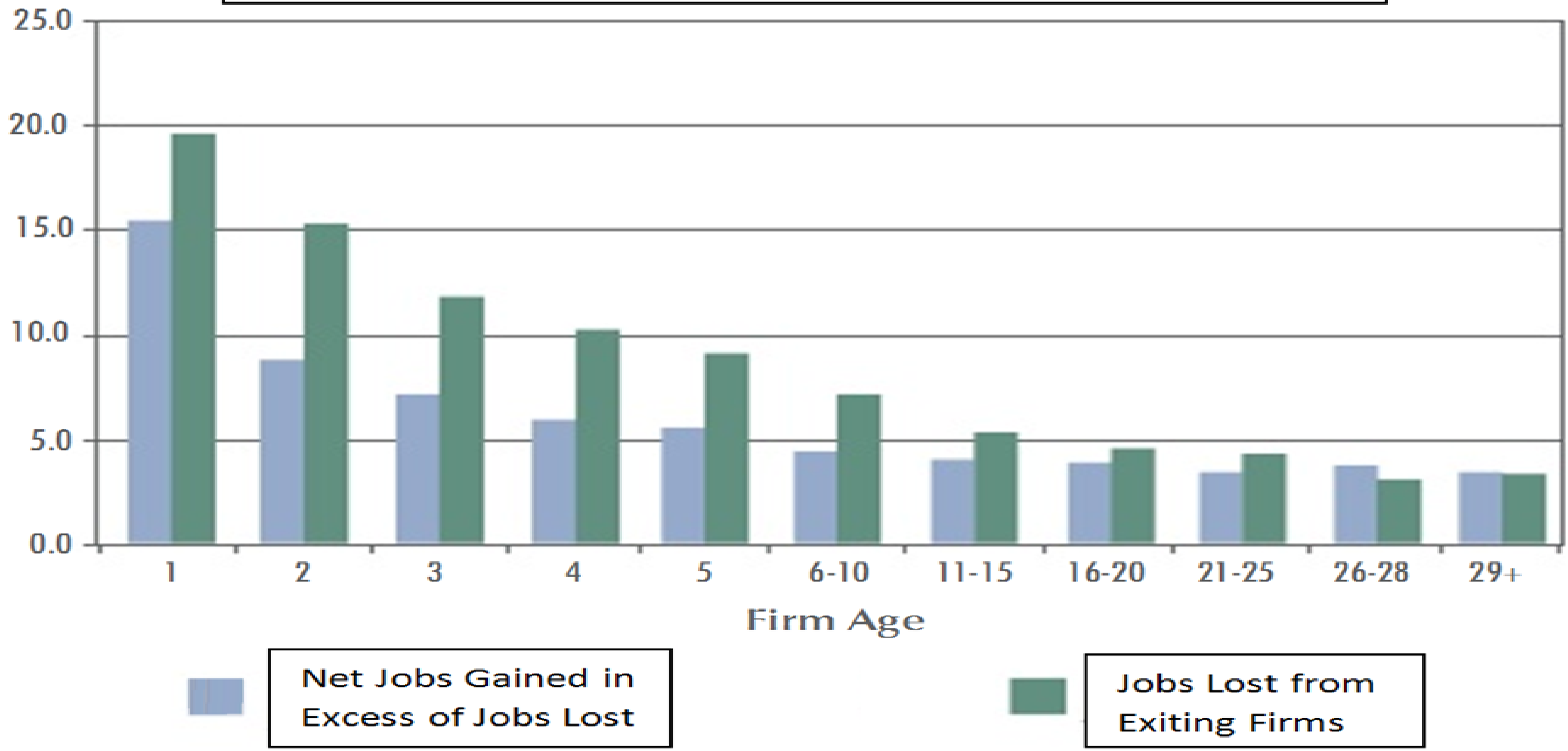
We can, however, ask if there are barriers that retard growth.

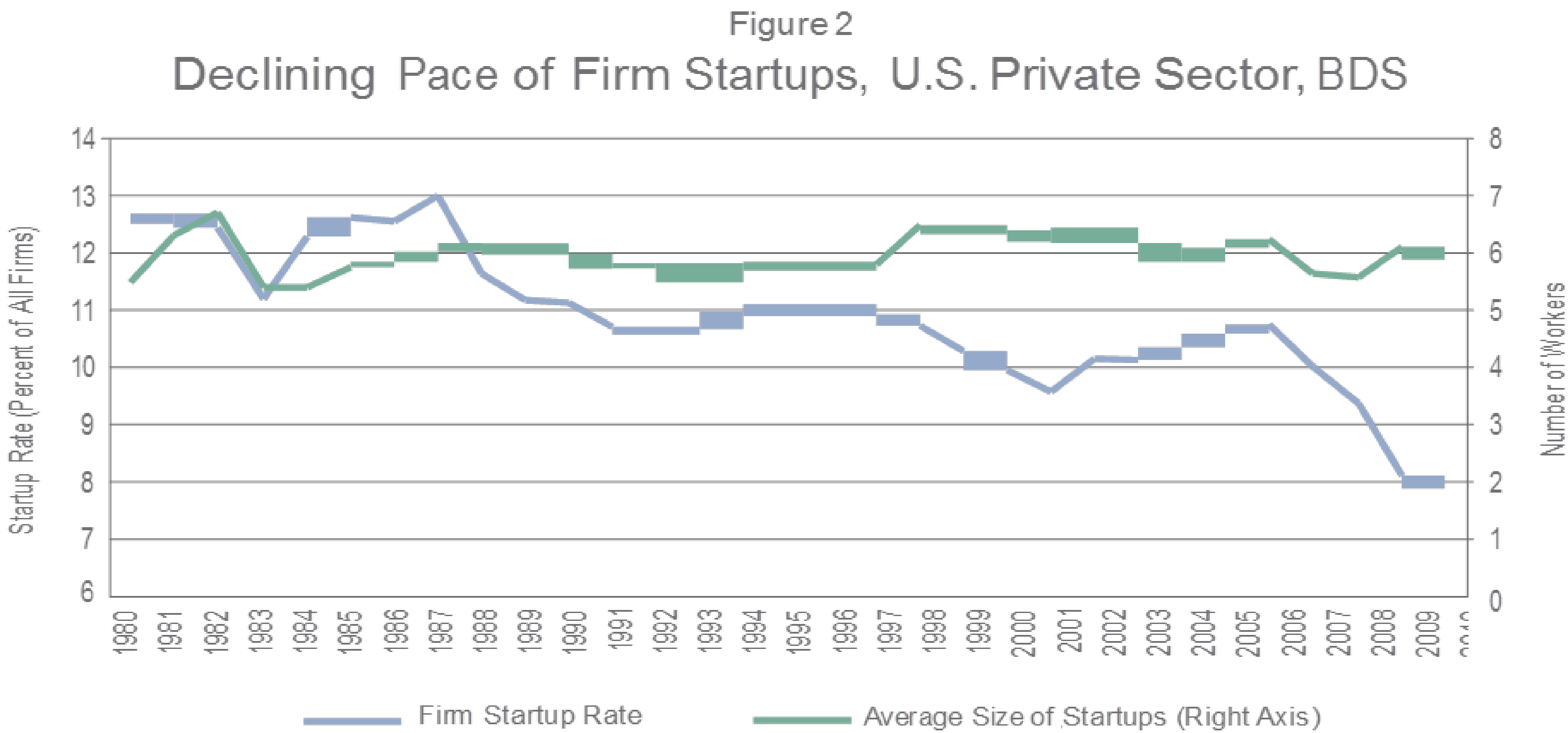
Young firms have historically been the engine of U.S. growth.

Young Firms and U.S. Growth in Employment (and Output).

(Source: Haltiwanger, et al (2009); Kaufman Census Bureau BDS)

Figure 9.1 Dynamics of Employment 1987-2005. Net Jobs Gained by Entering Firms in Excess of Jobs Lost by Exiting Firms





From Haltiwanger, et al (2012) "Where have all the young firms gone"
Kaufman Foundation, U.S. Census Bureau Business Dynamics Statistics

Proposal

- **Make it easier to start new businesses.**
- **Eliminate the corporate income tax**

THANK

YOU

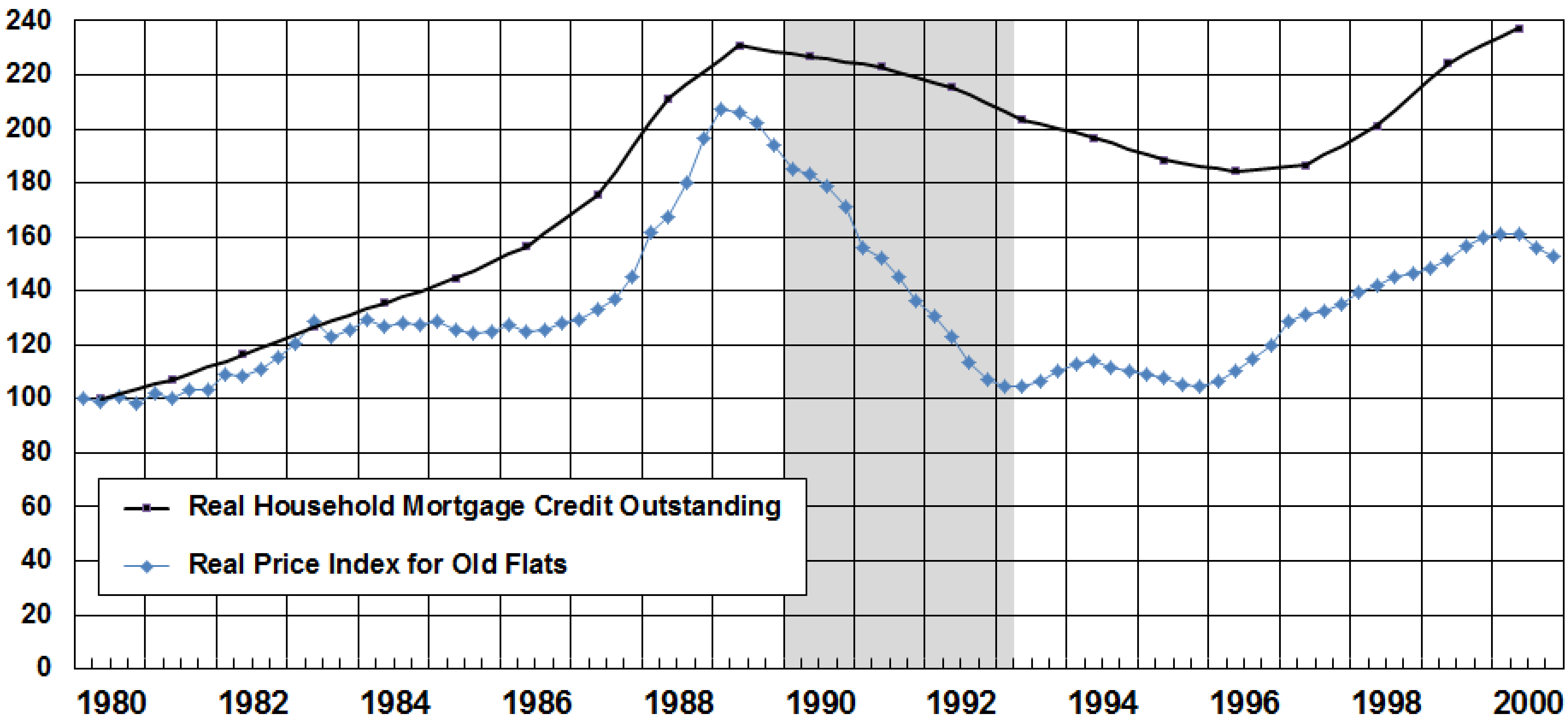
Housing bubbles in Finland and Japan: Contrasting Policy Responses and Outcomes

Steven Gjerstad

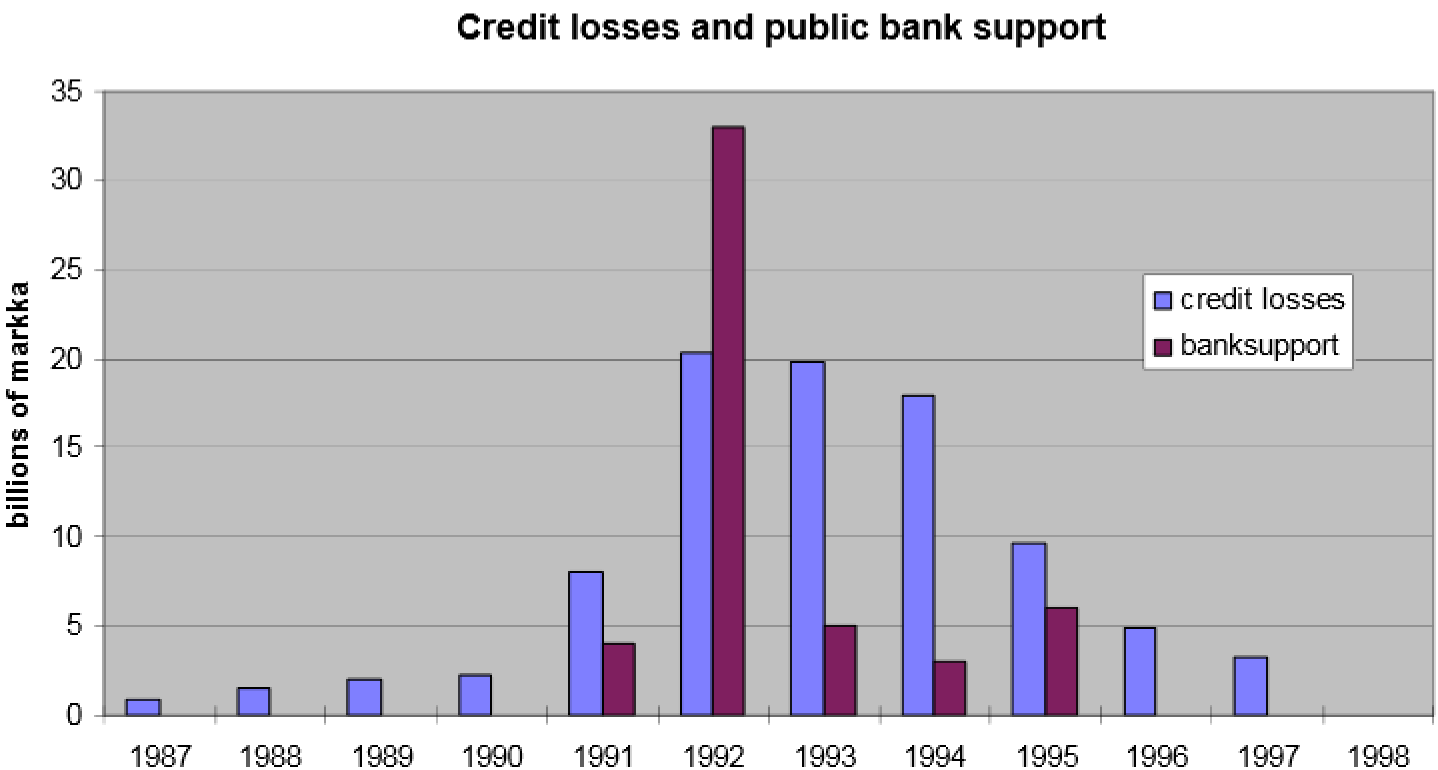
Directors' Roundtable

September 23, 2014

As in the U.S. in 2007, house prices collapsed in Finland before the general collapse began



- As house prices fell, banks' losses accumulated.
- Bank support was provided after bank equity was wiped out.
- Credit losses were about 18% of the GDP of 1 year.

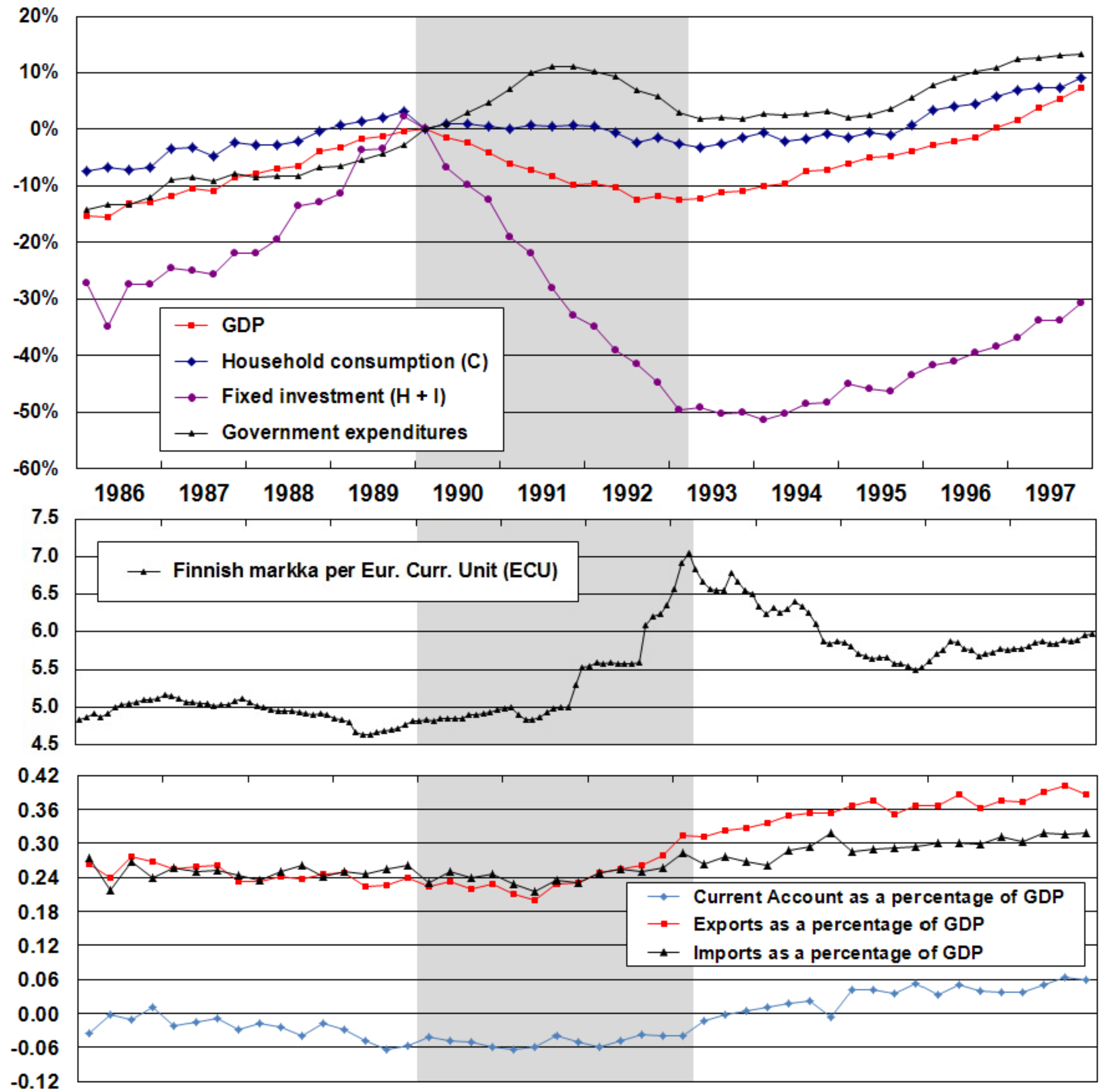


The Finnish collapse and recovery

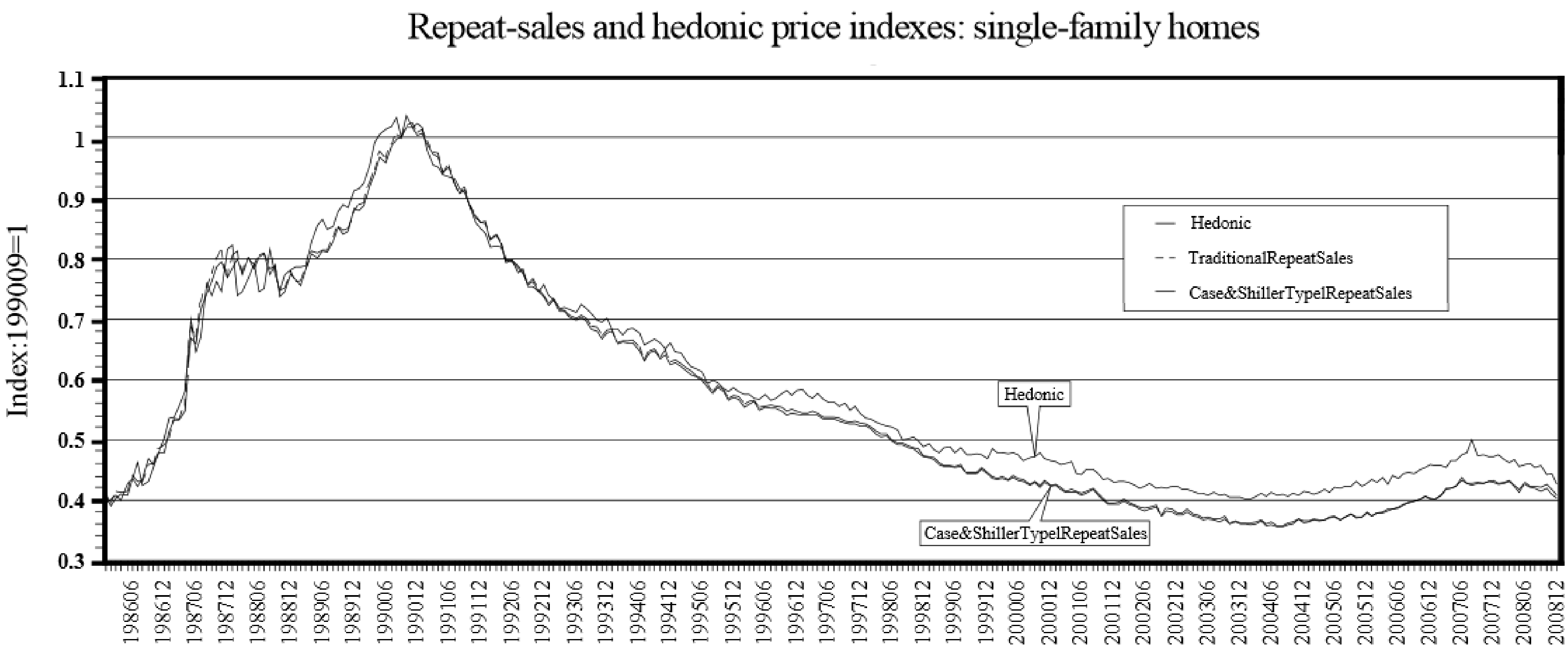
Fixed investment peaked in Q4 1989. GDP peaked the next quarter and then declined 12.6%.

Markka collapsed between Aug. 1992 and Feb. 1993. Then exports surged.

Finnish GDP grew at 2.9% per year from Q1 1993 to Q4 2007.

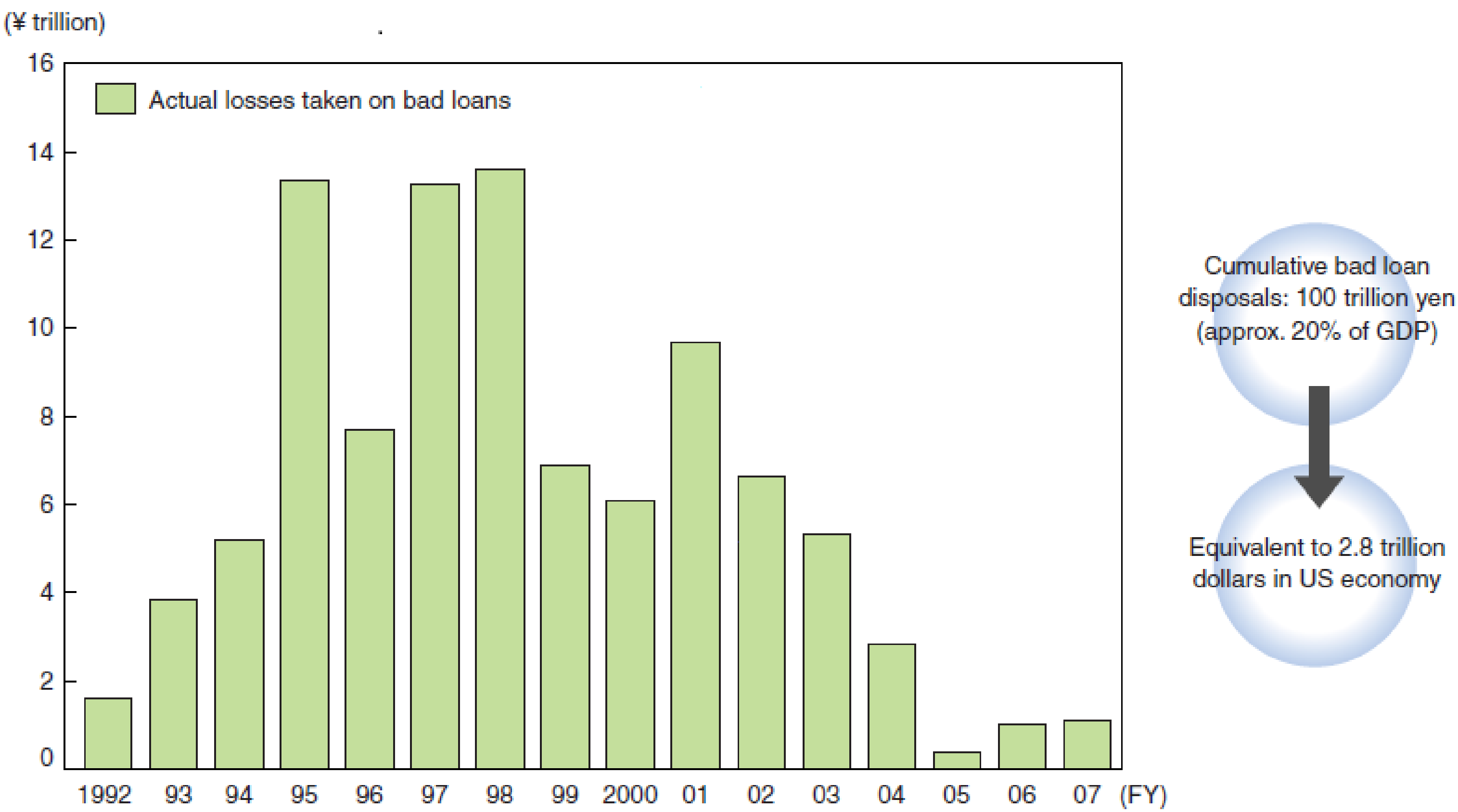


In Japan, a price index of single family homes peaked in 1990 and fell 65% over the next 14 years. The percentage decline in homes prices were as large as in the U.S. housing bubble by 1993, but banks were slow to recognize their losses.



Source: Shimizu, Chihiro and Tsutomu Watanabe (2010). "Real Estate Bubbles in Japan and the U.S.," Ministry of Finance, Public Policy Review.

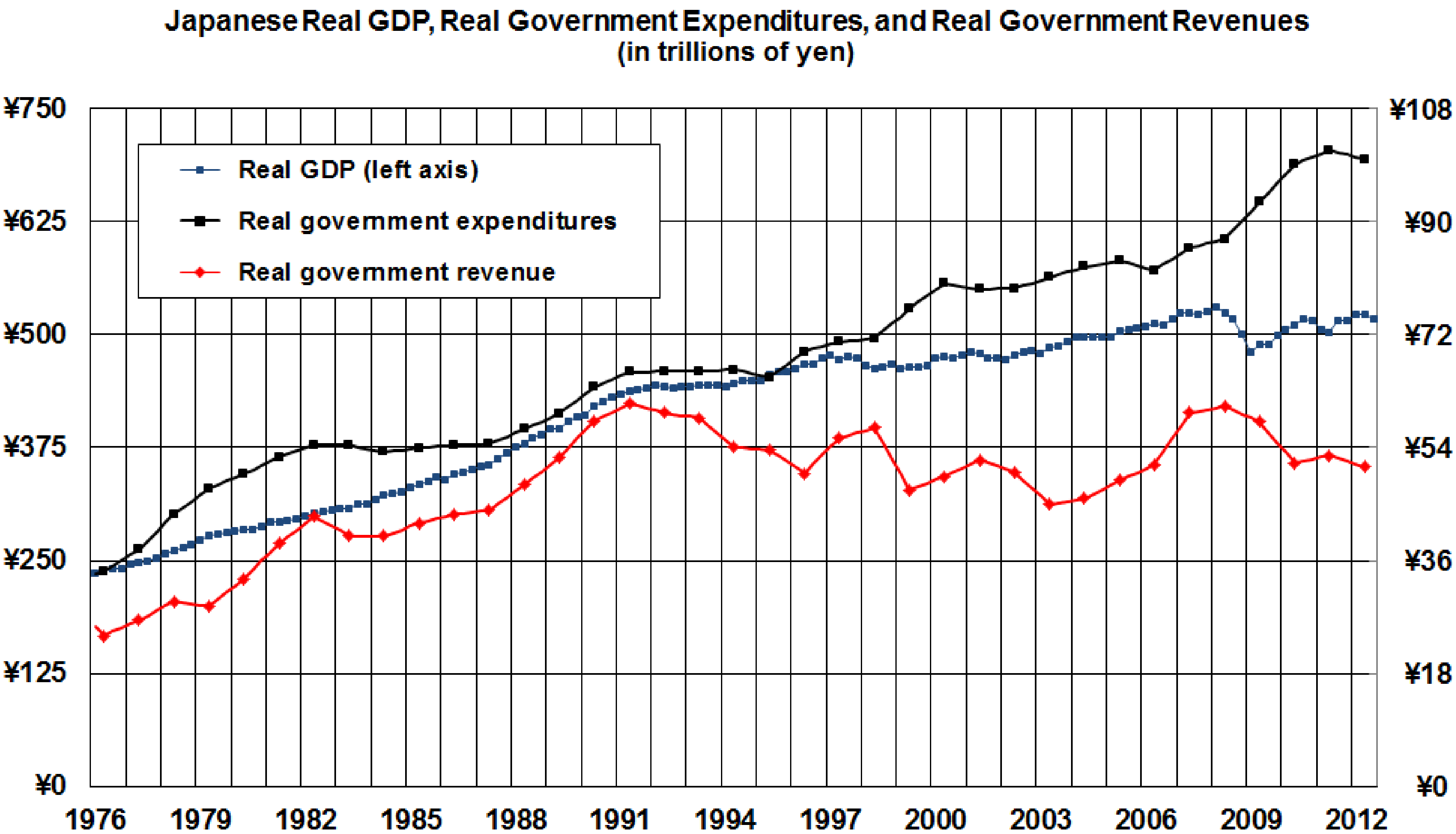
- **Although prices had fallen by 30% in 1993, only 5% of total losses had been recognized by that time.**
- **In March 2002, 8.4% of the loans of major banks were classified as non-performing.**



Source: Financial Services Agency, Nonperforming Loans.

Source: Koo, Richard and Masaya Sasake (2010). "Japan's disposal of bad loans: failure or success," Nomura Research Institute.

- **Two decades of deficit spending has produced a large debt but GDP growth has been very low.**
- **GDP grew at a rate of 1.5% per year from Q1 1992 to Q1 1997 and then only 0.7% per year from Q1 1997 to Q1 2008.**



Examples of past crises: Mexico

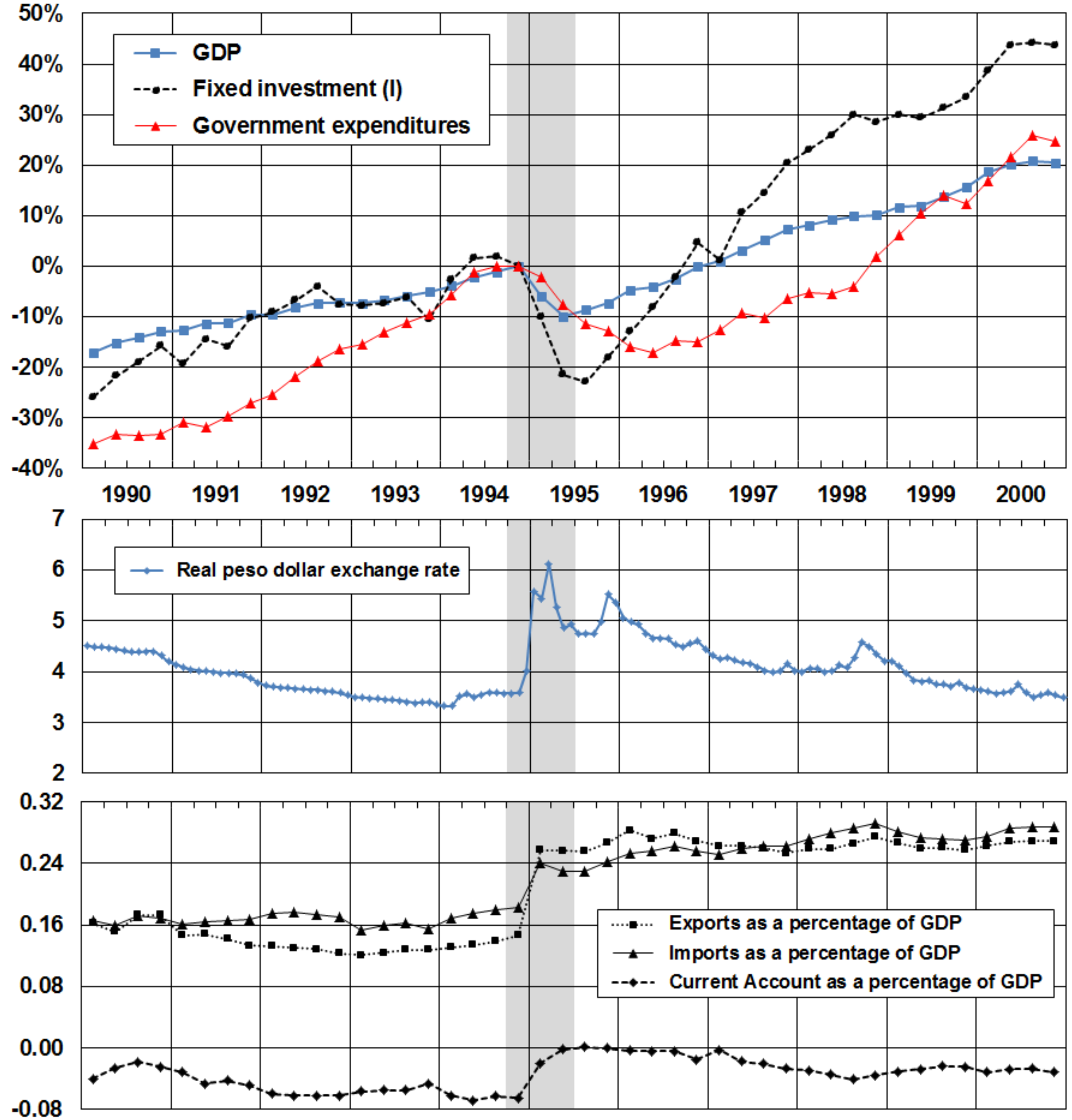
Mexico had a floating peg to the U.S. dollar from 1985 to late 1994.

Current account deficits averaged 6% of GDP from 1992 - 1994.

Peg collapsed in late December 1994.

The value of the peso fell 52% within 3 months.

GDP fell 9.9% in two quarters.



Profit, Revenue, and Profit Margin for Mexican Firms with over 40% of Sales in Exports in 1993 and 1994

1992

ID	Profit	Revenue	Margin
61	52,568	349,115	15.1%
265	267,850	2,521,990	10.6%
329	137,127	1,483,768	9.2%
314	43,393	628,543	6.9%
297	30,970	476,559	6.5%
173	204,727	3,177,733	6.4%
2	26,785	531,265	5.0%
325	8,857	191,729	4.6%
319	33,866	1,014,903	3.3%
172	(1,704)	76,021	-2.2%
28	(16,622)	336,141	-4.9%
342	(29,332)	208,948	-14.0%
48	(56,813)	289,343	-19.6%
	701,670	11,286,058	6.2%

1993

ID	Profit	Revenue	Margin
16	320,292	2,589,787	12.4%
329	207,716	2,224,736	9.3%
173	294,732	3,358,893	8.8%
61	36,683	428,631	8.6%
297	40,369	492,672	8.2%
342	10,438	129,833	8.0%
314	38,900	665,337	5.8%
2	30,564	548,422	5.6%
265	83,786	2,019,603	4.1%
165	(7,881)	2,879,879	-0.3%
319	(33,049)	781,092	-4.2%
325	(8,179)	187,875	-4.4%
172	(5,305)	84,342	-6.3%
28	(80,318)	258,828	-31.0%
48	(65,749)	173,656	-37.9%
	863,000	16,823,586	5.1%

1994

ID	Profit	Revenue	Margin
265	241,931	2,379,328	10.2%
173	255,396	3,918,870	6.5%
2	30,711	710,076	4.3%
329	(59,735)	3,408,076	-1.8%
28	(24,100)	285,767	-8.4%
16	(316,434)	3,076,817	-10.3%
325	(24,589)	213,744	-11.5%
165	(481,752)	3,762,706	-12.8%
314	(269,011)	1,564,086	-17.2%
48	(62,824)	198,877	-31.6%
61	(153,756)	471,005	-32.6%
297	(255,782)	556,532	-46.0%
172	(34,588)	60,632	-57.0%
342	(156,723)	261,023	-60.0%
319	(623,705)	973,925	-64.0%
	(1,934,962)	21,841,464	-8.9%

1995

ID	Profit	Revenue	Margin
165	3,091,516	6,420,312	48.2%
265	1,121,622	3,664,529	30.6%
48	74,902	371,247	20.2%
173	945,159	4,880,002	19.4%
28	74,448	442,647	16.8%
16	1,007,462	6,125,752	16.4%
297	110,023	876,892	12.5%
329	239,085	2,933,964	8.1%
2	71,424	1,053,880	6.8%
319	116,213	1,839,922	6.3%
325	5,763	245,357	2.3%
342	(37,818)	236,265	-16.0%
314	(391,799)	1,933,848	-20.3%
61	(116,647)	524,442	-22.2%
172	(13,603)	60,502	-22.5%
	6,297,750	31,609,560	19.9%

1996

ID	Profit	Revenue	Margin
319	878,188	2,537,070	34.6%
165	1,573,007	4,928,026	31.9%
265	937,002	3,366,346	27.8%
48	106,873	426,338	25.1%
297	228,185	987,652	23.1%
325	64,788	297,567	21.8%
16	1,184,120	5,867,474	20.2%
172	13,801	72,212	19.1%
28	89,485	506,941	17.7%
173	808,306	5,857,497	13.8%
61	61,567	643,211	9.6%
2	98,576	1,048,748	9.4%
342	20,453	240,974	8.5%
329	209,095	2,815,854	7.4%
	6,273,446	29,595,908	21.2%

1997

ID	Profit	Revenue	Margin
319	737,139	2,477,134	29.8%
165	1,168,658	4,495,302	26.0%
265	677,668	3,158,587	21.5%
48	91,506	431,275	21.2%
16	1,083,030	5,668,712	19.1%
297	159,589	994,986	16.0%
2	121,311	1,100,861	11.0%
28	49,219	448,838	11.0%
173	301,677	4,682,355	6.4%
342	8,734	286,411	3.0%
61	15,878	663,094	2.4%
329	23,075	3,170,080	0.7%
314	(27,719)	1,275,154	-2.2%
	4,409,766	28,852,789	15.3%

Data are from 361 firms traded on the Bolsa Mexicano de Valores.

Selected firms had over 40% of sales in exports in 1993 and 1994.

Firm 165: Grupo Mexico – 3rd largest copper producer in the world.

Firm 319: Tubos de Acero de México, S.A. (TAMSA) –oil pipe manufacturer.

Firm 265: Industrias Peñoles – 2nd largest Mexian mining company.

The Directors Roundtable

Chapman University

Dana Kopper, Managing Director

September 23, 2014

Today’s Environment:

How Do We Encourage Good Faith Risk Taking?

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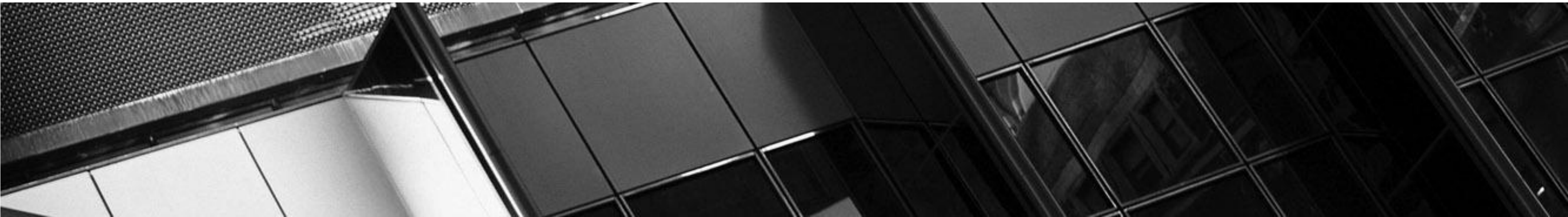


Domestic & International Environmental Scan…

Continuing Challenges / Evolving Risks: D&O Market Reactions:

Loss Ratios: High. Result: Increased Scrutiny; Premiums; and Retentions

Judicial	Litigation Trends
Legislative	SOX / Dodd Frank; Heightened Board Oversight
Regulatory / DOJ	Investigations; Enforcement Actions; Whistleblowers; Individuals & Gatekeepers
Plaintiffs	Securities Class Actions; Opt Outs; Derivatives; M&A Litigation

SEC Investigations / Enforcement Actions

- **Investigations**
  - 908 Opened in FY 2013 (13% Increase)
  - 574 Formal Orders of Investigation in FY 2013 (20% Increase)
  - FY 2014 will exceed FY 2013
- **Enforcement Actions**
  - 686 in FY 2013
  - Thus far in FY 2014 – on path to meet or exceed FY 2013
  - FCPA cases thus far in FY 2014 have exceeded all filings in FY 2013
- **Disgorgements**
  - 96 Separate Actions in FY 2013
  - 161 Individuals & Corporate Entities in FY 2013
  - $3.4 Billion Paid in FY 2013

SEC Investigations / Enforcement Actions

- Task Force – Financial Reporting and Audit (FRAud) (aka RoboCop)
- Gatekeeper Focus (Lawyers / Accountants / Advisors – And Per SEC Chair White – Directors
- Whistleblower Activity & Quality Up / 3,000+ Per Year
- New Settlement Policy – Admission of Facts and Misconduct – Limited Current Use

Selected Cornerstone Research 2013 Settlement Data

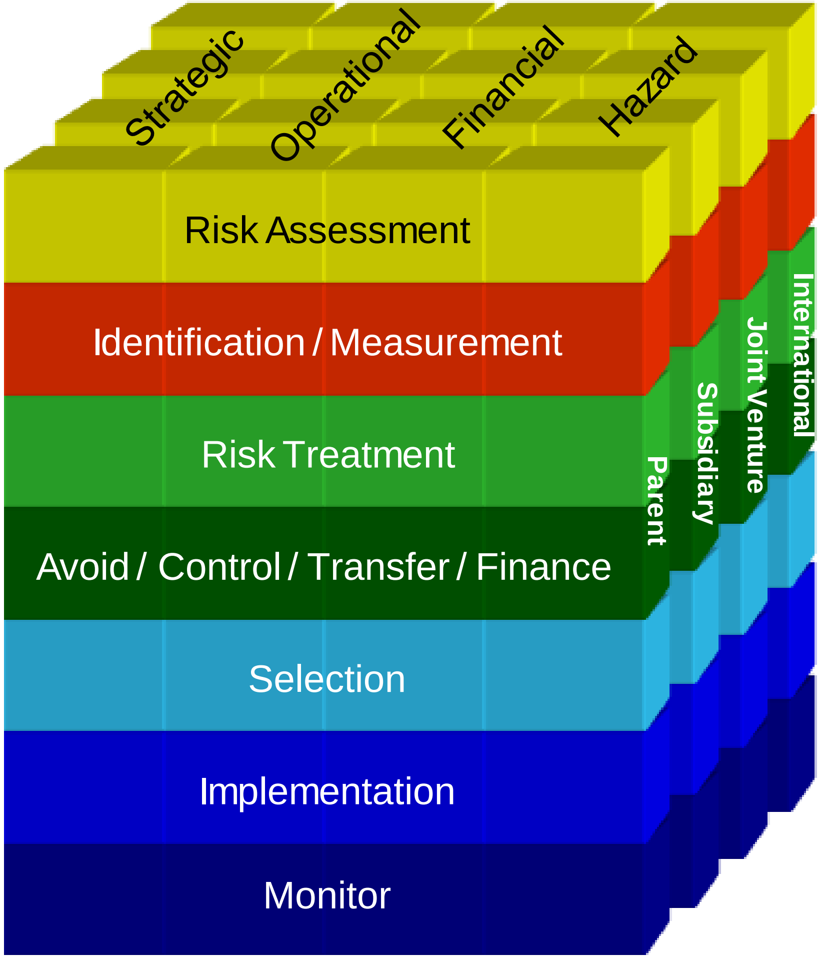
- **Securities Class Action Filings:**
  - Up 9%
  - Still 13% Below 1997 to 2012 Average
- **Average Settlements:**
  - $71.3MM versus $55.5MM in 2012 (skewed by small number of large settlements)
- **Median Settlements:**
  - $6.5MM versus $8.3MM in 2012
- **Median Settlements w/ Public Pension Institutional Lead Plaintiff:**
  - $23MM versus $21MM in 2012

Selected Cornerstone Research 2013 Settlement Data

- **Cases With Corresponding SEC Action:**
  - Higher Settlements – Greater Than 2X Multiplier
- **All Settlements:**
  - 60% < $10MM
  - 79% < $25MM
  - 88% < $50MM
- **Public Company Securities Class Action Total:**
  - 3.3% of All Public Companies – Adjusted for 2013 Total Number of Public Companies versus 2.8% from 1997 to 2012

Enterprise Risk Management

Foundational Platform For Today's Complex Environment



- **Strategic**
  - Competition, Social, Capital Availability, Merger, Acquisition
- **Operational**
  - Cyber, Product Failure, Regulatory, Compliance, Internal Controls, Integrity, Reputational
- **Financial**
  - Pricing Risk, Asset Risk, Currency Risk, Liquidity Risk, Credit Risk, Investment Management Risk
- **Hazard**
  - Property Damage, Income, Liability, Personnel

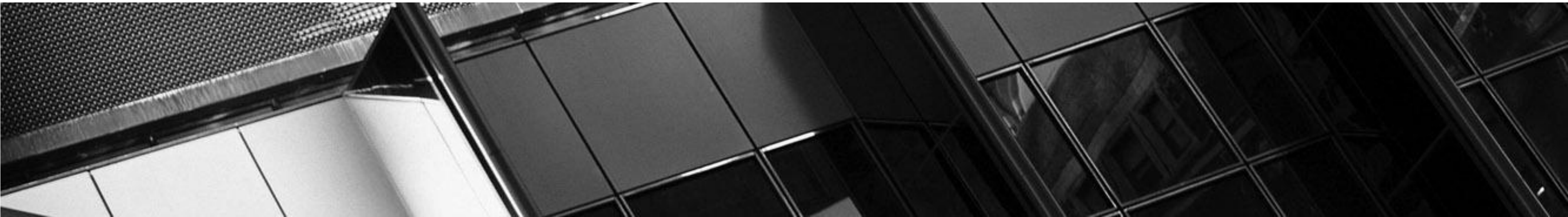
Integrating Risk Management Strategies

CORE BENEFITS

- Reduced Risk Profile
- Reduced Cost of Risk
- Enhanced Personal and Organizational Asset Protection

Governance Risk Management

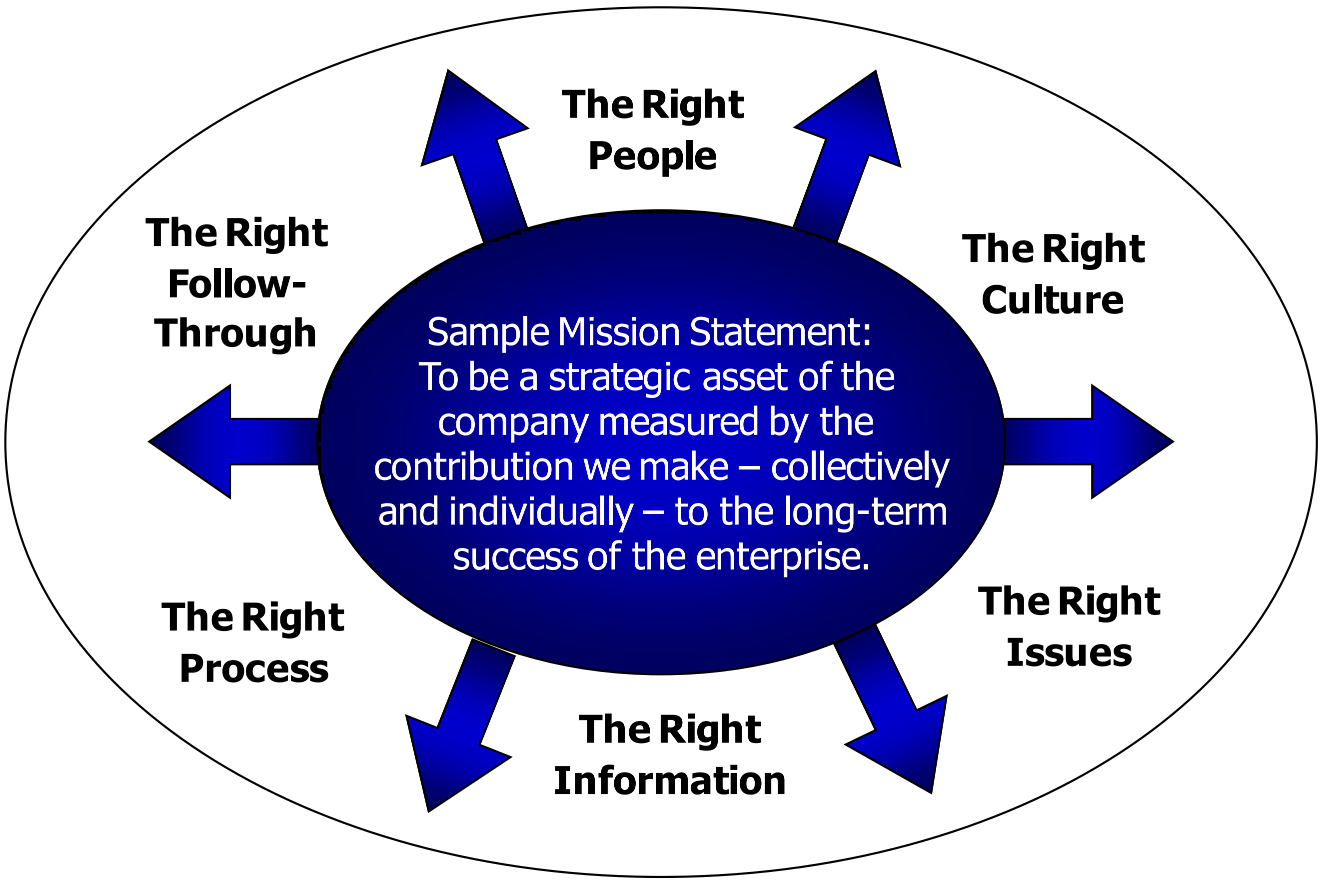
Management & Professional Liability



Board Dynamics…

Structure Versus Execution…Substantial Source of D&O Claims
More Than Guidelines, Charters & Checklists …

These High-Performance Characteristics…



…Foster Superior Shareholder Value & Risk Mitigation

How Effective Are We?

Sample Core Areas of Board Governance

- Structure & Composition
- Director & CEO Compensation
- Strategic Planning
- Processes & Procedures
- Interaction
- Information
- Committees
- Roles & Responsibilities
- Accountability Methods
- Risk Oversight; Organizational Compliance Efficacy
- Code of Conduct & Ethics

How Engaged Should We Be?

LEAST INVOLVED — MOST INVOLVED

The Passive Board

- Functions at the discretion of the CEO.
- Limits its activities and participation
- Limits its accountability
- Ratifies management's preferences

The Certifying Board

- Certifies to shareholders that the CEO is doing what the board expects and that management will take corrective action when needed.
- Emphasizes the need for independent directors and meets without the CEO.
- Stays informed about current performance and designates external board members to evaluate the CEO.
- Establishes an orderly succession process.
- Is willing to change management to be credible to shareholders.

The Engaged Board

- Provides insight, advice, and support to the CEO and management team.
- Recognizes its ultimate responsibility to oversee CEO and company performance; guides *and* judges the CEO.
- Conducts useful, two-way discussions about key decisions facing the company.
- Seeks out sufficient industry and financial expertise to add value to decisions.
- Takes time to define the roles and behaviors required by the board and the boundaries of CEO and board responsibilities.

The Intervening Board

- Becomes intensely involved in decision making around key issues.
- Convenes frequent, intense meetings, often on short notice.

The Operating Board

- Makes key decisions that management then implements.
- Fills gaps in management experience.

Individual Contractual Indemnity
A Critical Tool

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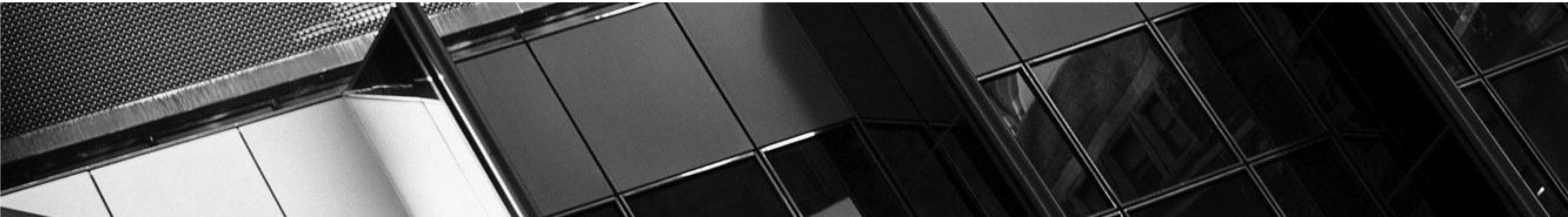

Indemnification…Generally

3	**Contractual Indemnity Agreements** (Contract Between Individual and Company)
2	**Articles of Incorporation/Association/Bylaws** (All Directors and Officers)
1	**Statutory**

Harmonized Indemnification

PE Funds & International

Indemnity Agreements
Individual and Portfolio Interface
5

Company

Contractual Indemnity Agreements
(Contract Between Individual and Company)
4

Articles of Incorporation / Bylaws
(All Directors and Officers)
3

Statutory
2

Transaction

Purchase & Sale Agreement
1

International Indemnity Topics
A Partial Sampling

- **Individual contractual agreements (U.S. and international) expand and clarify the nature and scope of indemnification.**
- **Enhanced indemnification will create more financial risk for funding organization.**
- **Enhanced indemnification is consistent with original intent of indemnification to encourage good faith risk-taking on the part of directors and officers.**

- Mandate indemnification
- Not prohibit indemnification for gross negligence, recklessness, etc. (standards of conduct)
- Mandate advancement of defense expenses "on demand"
- Terms to discourage wrongful refusals to indemnify; enhance enforcement rights
- Create individual contractual rights that cannot be unilaterally amended, or misinterpreted by successor organizations
- Expand expense definition to include federal, state, local, or foreign taxes based upon actual or deemed receipt of indemnity payments or advancements
- Specify outside directorships
- Provide right and prosecution costs to enforce rights
- Accelerate determination process
- Clarify lack of action to be deemed favorable determination
- Provide appropriate severability provisions
- Burden of proof on corporation to overcome indemnity presumptions; order or plea not determinative of good faith conduct
- Provide litigation appeal rights
- Strengthen binding effect provisions in change of control situations

D&O Liability Insurance Overview

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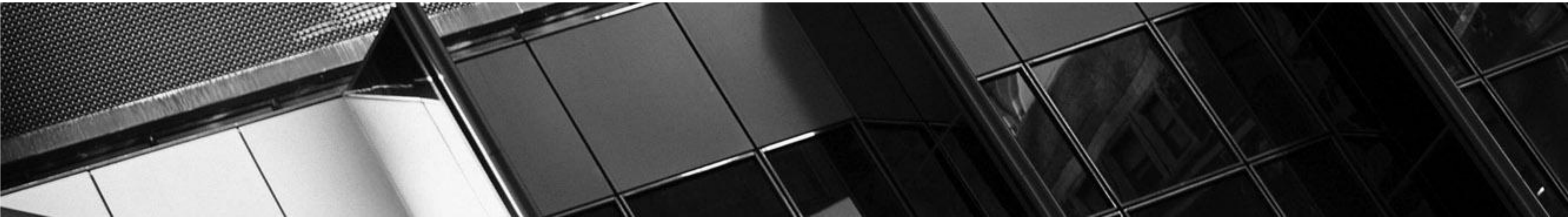

D&O Liability Insurance Coverage Part Overview

Including Enhanced Personal Asset Protection (DIC)

Important Note: Terms, conditions, limitations, exclusions, and exceptions apply.

Enhanced Personal Asset Protection (DIC)

Coverage A

Excess & Difference-In-Conditions (DIC) Policy

$25MM Aggregate Limit

Enhanced Personal Asset Protection

- *Dedicated limits personal asset protection which cannot be impaired by corporate liabilities.*
- *Non-rescindable under any circumstance.*
- *Drop Down Provision (When Underlying Insurance or Indemnification Fails.)*
- *Broader Coverage (Insuring Agreements / Definitions)*
- *One Conduct Exclusion for Officers (Adjudicated Personal Conduct with Defense Cost Carve Back)*

$50MM Aggregate Limit

Coverage A	**Coverage B**	**Coverage C**
Personal Asset Protection For Non-Indemnifiable Claims	Corporate Asset Protection For Indemnifiable Claims	Corporate Asset Protection For Corporate Entity Securities Claims (Public) All Claims (Private)
Retention Nil	**Retention $500K**	**Retention $500K**

Traditional D&O Insurance

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International D&O and E&O Notes…

- **Top 10 Countries With Mature D&O Liability Systems / Laws**
  1. Australia
  2. Canada
  3. England
  4. France
  5. Germany
  6. Hong Kong
  7. Italy
  8. Japan
  9. Korea
  10. The Netherlands

- **Up & Coming Jurisdictions – Economically More Powerful Than Most of the Top 10**
  - ✓ **Brazil**
  - ✓ **China**
  - ✓ **India**

- ***Summary Notes***
  - Public & private company D&O litigation trending upward.
  - Mature D&O liability systems (Top 10) all include specific laws focused on right of civil and criminal remedies for class or mass tort actions.
  - Heightened awareness of individual culpability within corporate settings, especially amongst regulators.
  - Aggrieved overseas investors seek litigation alternatives outside of the U.S.
  - Anti-Corruption/Anti-Bribery Laws: FCPA; UK Bribery Act; OECD based; United Nations conventions far reaching.
  - Enforcement and follow-on civil actions increasing significantly and now converging with domestic enforcement