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Where Were the Regulators?

by John Slayton, JD, LL.M.-TAX, CFP®

"I am from the Government and I am here to help you."

We have previously investigated the impact of derivatives, shadow banking and Government Sponsored Enterprises (Fannie and Freddie) on the economic and market collapse the world has suffered this year. The foundation for this disaster was not laid overnight and responsibility is widespread. What role did the federal government play?

In the movie *The Perfect Storm*, a heroic George Clooney fared poorly against a massive wave caused by the confluence of three separate incredibly violent storms atop his small fishing vessel. When I review this year's events, I cannot avoid recalling that final scene of Clooney's boat trying to grind its way up the face of that huge wave, only to collapse backward, capsize and be swept away. A real estate bubble, historically low interest rates, yield-starved investors, creative, hungry (maybe even greedy) Wall Street Wizards, short-sighted misinformed politicians and lackadaisical regulators combined to create the Perfect Financial Storm in 2008.

Housing

Both Congress and the last two Administrations have ardently advocated making home ownership more available for persons of any income level. In 1992, Congress started pushing Fannie and Freddie to increase loans to below-median income borrowers. In 1995, Congress amended the Community Reinvestment Act to require banks to increase loans to below-median income borrowers. In 1996, HUD set the target for Fannie/Freddie below-median income loans at 52% by 2005. Fannie/Freddie became heavily involved with sub-prime mortgages. In December 2003, President Bush signed the *American Dream Downpayment Act* into law, a \$200 million per year down payment and upfront closing cost assistance program. When the housing bubble burst and mortgages began to fail, Fannie/Freddie were left with insufficient capital to continue servicing their debt and they



NOTABLE QUOTE

"A little neglect may breed mischief... for want of a nail, the shoe was lost; for want of a shoe, the horse was lost; and for want of a horse, the rider was lost."

– Benjamin Franklin

The Trust Company of the South is a fee-only independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

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were taken over by the Treasury in September at a current, but increasing, taxpayer cost of \$150 billion. The federal government effectively sponsored the housing bubble and the sup-prime mortgage fiasco.

During the same period, other factors strengthened the housing dimension of the Storm. The Taxpayer Relief Act of 1997 increased the capital gains exclusion on the sale of a principal residence from \$125,000 to \$500,000. Housing gains became tax-preferred over gains in other investments. In January 2001, the Fed started lowering the Fed funds rate from 6%, bottoming in June 2003 at a 40-year low of 1%. Mortgage rates dropped to 40-year lows as well. U.S. homeownership increased from 65% in 1996 to 70% in 2007. At the same time, the average price of a U.S. home doubled and, in 2007, at least 30% of new mortgages involved no downpayment. The issuance of subprime or “teaser rate” adjustable rate mortgages were not a problem as long as house prices continued their consistent upward trend. This trend unfortunately reversed in 2006.

In addition to stoking the demand for cheap mortgage money, the historically low interest rates created a demand from investors for higher fixed income yields. No one was excited by a 1% return on a money market fund, CD or T-bill. Two different demands had emerged – one for mortgage money at low rates and one for investments with higher yields. The missing link was a vehicle to satisfy both of these needs simultaneously. Enter the Wizards of Wall Street, with the active assistance of the federal government.

Financial Institutions and Derivatives

The financial industry has undergone a myriad of changes in its structures, activities, product offerings and regulation during the last ten years. In November 1999, the *Gramm-Leach-Bliley Act* reversed rules in place since the Great Depression that separated commercial and investment banking, facilitating an explosion of bank mergers and cross-ownership between various financial institutions. This threw the financial regulatory system into a state of confusion.

Derivatives are the instruments that allowed sub-prime mortgages to be securitized and sold to financial institutions, traders, hedge funds, school boards and

towns all over the world. In the 1990s, debate raged over whether the trillions of dollars of derivatives should be regulated by the SEC as securities, by the Commodity Futures Trading Commission (“CFTC”) as commodities or by the states as insurance. In 1997, the Chair of the CFTC testified before Congress that the unfettered, opaque trading of derivatives could threaten regulated markets and the entire economy without any federal agency knowing about it, suggesting greater disclosure of trading and reserves to cushion against losses. Alan Greenspan, Chair of the Fed, and Robert Rubin, then Treasury Secretary, but now Vice Chairman of Citigroup, fiercely opposed such regulation, for fear that the derivatives business would go offshore and be lost to Wall Street. The debate was settled by the *Commodity Futures Modernization Act (CFMA)*, which was shepherded by Sen. Phil Gramm (then chair of the Senate Banking Committee and now Vice Chairman of UBS, one of the largest derivative generators), attached to a crucial appropriations bill and passed without any floor debate in December 2000. The *CFMA* defined derivatives (even credit default swaps) as unregulated commodities, rather than regulated securities or insurance products. Astoundingly, *CFMA* drafters felt it necessary to exempt Wall Street from the New York gambling restrictions, lest the sale of derivatives, such as credit default swaps, be confused with illegal casino operations.

The Wall Street Wizards were now free to create innumerable derivative instruments, pooling thousands of sub-prime mortgages and slicing the pools into numerous tranches of security, allowing the rating agencies to place high credit quality ratings on the senior tranches. This allowed participations in these pools to be marketed to investors as higher yielding, apparently low risk, debt instruments. Largely unregulated mortgage brokers placed sub-prime mortgages and then flipped them to investors in securitized mortgage pools. This was the magic carpet that met the needs of borrowers for low interest mortgages, while providing high yielding debt instruments for participating investors. As long as house prices increased, default by individual sub-prime borrowers was not problematic – the financial institution could always sell the house for more than the mortgage. Regrettably, house prices also fall.

In July 2002, following the collapse of Enron,

Congress adopted *Sarbanes-Oxley*, significantly increasing the oversight and accounting disclosures required of public companies. FASB 157, which requires banks to mark all assets to market daily, was adopted in November 2007. Illiquid assets, such as credit default swaps, are hard to value and when the market collapses, the banks must keep marking them down, further weakening their balance sheets. Many have argued that the mark-to-market rule required Bear Stearns, Fannie/Freddie, Lehman Brothers, Wachovia, AIG and Washington Mutual to write their assets down to unrealistic values, accelerating their precipitous demise.

At perhaps the peak of the deregulation movement, in April 2004, the SEC bowed to the wishes of the five largest brokerage firms, led by Hank Paulson at Goldman Sachs, and voted that the five were so well capitalized that they should be treated as *Consolidated Supervised Entities (CSEs)*. The SEC revoked the 1975 vintage 12:1 debt to net capital rule, allowing *CSEs* to determine the appropriate level of leverage, several of whom decided that 50:1 was more appropriate than 12:1. The SEC freed the top five brokerage firms to multiply their leverage several times over, allowing more derivative creation and balance sheet weakening. The SEC was given total access to the *CSEs* to monitor their businesses, but instead assigned only seven lower level staffers the task of “supervising” these five *CSEs* and their \$4 trillion in assets. No effective monitoring ever resulted and the *CSE* program has been abandoned. Until the recent Bernard Madoff debacle, this had to be the SEC’s most embarrassing moment.

The Storms Collide – The Perfect Storm Emerges

Congress and two Administrations agreed that home ownership by all levels of earners was good public policy. HUD, Fannie and Freddie accomplished this goal, enhancing the housing bubble and the sup-prime mortgage crisis.

- >> To recover from recession, the Fed drove mortgage rates to historic lows, making debt more affordable and house prices higher and creating investor demand for higher yielding fixed income instruments.
- >> Leaders of Congress, the Fed and Treasury coalesced in a fervor of deregulation, mistakenly trusting in the good will, lack of greed, rationality and skill of Wall Street.
- >> Congress exempted derivatives from any effective

regulation, enabling the Wall Street Wizards to create and market a vehicle to provide both low mortgage rates and high investment returns, without having adequate equity to support them.

- >> The SEC revoked the 12:1 debt to net capital rule, permitting the firms to multiply their leverage several times, significantly eroding the soundness of their balance sheets and enhancing their risk.
- >> Congress directed the adoption of FASB 157, requiring banks to continuously mark illiquid hard-to-value assets down as the market softens, further weakening their balance sheets.

We are all aware of the fall-out of this storm in 2008. Approximately \$2 trillion in taxpayer funds have been allocated to notable financial implosions and stimulus packages – Bear Stearns, Fannie/Freddie, AIG, Washington Mutual, IndyMac and Citigroup. Others have reorganized themselves without federal funds – Goldman Sachs, J.P. Morgan, Merrill Lynch and Wachovia. Lehman Brothers simply went away.

Do not dismiss this Storm as the product of clever, greedy Wall Street Wizards creating instruments that no one understands (but pay high commissions) and unregulated, unscrupulous mortgage brokers duping low-income sub-prime borrowers and then flipping the mortgages through securitization. The demand for sub-prime mortgages to attain the American Dream and the thirst on the part of investors for higher yields was the demand met by Wall Street’s supply. I explain to my finance students at Elon University that the financial services industry is the conduit through which capital flows from the capital-rich investors to the capital-poor borrowers. The objective of regulation is to see that the conduit is free of wrongdoing and fair to all involved parties. The Perfect Financial Storm could not have formed had adequate regulation been in place.

We hope that understanding the underlying causes of the current financial crisis will help you cope with its ramifications and incorporate them into your long term investment approach. *To be informed is to be empowered.* Always seek to keep your focus on your long term investment objectives. Be aware of short term anomalies, but key on the long term risks and returns.

***“We are not from the Government,
so we truly are here to help you.”***

Behind the Scenes at Trust Company of the South

- >> **John Slayton** appeared in two public panel presentations, discussing the economic and market crises, sponsored by the Love School of Business (October) and the Department of Accounting & Finance of the Love School of Business (November), both of Elon University.
- >> **Jill Sweat** spoke at the Trust Club at Campbell University in November on the various challenges and requirements that are necessary to obtain a Certified Financial Planner® designation (CFP®).
- >> **Will McPherson** attended and successfully completed Cannon Trust 1 in October at Kingston Plantation.
- >> **Mike Palmer** was featured in the October edition of *Triangle Business Journal's* annual Money Managers Roundtable article.
- >> **Bill Noble's** son, Will, recently received the rank of Eagle Scout, the highest ranking available by the Boy Scouts of America. Congratulations Will!

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Tax Planning for 2009 and Beyond

Christopher N. Sutherland, CPA

Looking back at 2008 we saw the end of a four year run of healthy growth and modest inflation. Many economists think the slowdown in the economy will continue through 2009 and possibly beyond. Almost all shifts in the economy bring changes to the tax code. This year is no different. We've already seen several new tax laws in 2008 including the Economic Stimulus Act and you should expect many more in 2009 with a new presidential administration taking the reins.

>> **Alternative Minimum Tax (AMT)** – The AMT was originally designed to ensure high-income taxpayers would pay at least a minimal amount of tax. Because the AMT exemption is not indexed for inflation, many more people have been hit with this tax. From 1990 to 2006 the number of taxpayers paying AMT increased from 200,000 to over 4 million. Taxpayers in North Carolina are particularly susceptible to AMT due to our high state tax rate. It is possible Congress will start serious debate about long term changes to the AMT system in 2009.

>> **Investing and Taxes** – As it stands now, the 15% tax rate on long term capital gains is scheduled to run through 2010 at which time it reverts back to 20%. For many taxpayers that rate could be higher as President-elect Obama has proposed a 28% capital gain rate for certain taxpayers. Why not try to reduce that future tax burden now?

With the stock market down approximately 40%, you likely have unrealized losses in your investment portfolio. You may have thought about realizing some of those losses to offset gains or even a little beyond to take advantage of the maximum \$3,000 loss against ordinary income. Why not realize as much loss as possible to be used against capital gains in the future? By realizing a \$20,000 loss now, you may save as much as \$7,000 in taxes later.

>> **Retirement Planning** – Congress recently passed a law suspending required minimum distributions (RMD) for 2009 for taxpayers age 70 1/2 or older and for those with inherited IRAs. This means taxpayers who likely have seen their IRA value fall considerably do not have to take an otherwise disproportionately high percentage from their accounts.

The income limitation on converting traditional IRAs to Roth IRAs is eliminated in 2010. (See *Compass* Summer 2008 for more on this.) For those taxpayers not eligible to contribute to a deductible IRA, consider contributing to a nondeductible IRA with the intention of converting to a Roth IRA in 2010. Only the appreciation in the account would be subject to tax and you can elect to have the income spread through 2012.

Do you have young children or grandchildren that work a part-time job? Consider contributing funds to a Roth IRA to get them started down the path to a secure retirement. As little as \$12,000 contributed during their teenage years could result in over \$500,000 for your child or grandchild at the age of 65. Up to \$10,000 of Roth IRA funds are also available tax-free and penalty-free toward the purchase of a first home.