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# Beyond the subprime bomb

Book review and interview: 'Financial Shock'

BY PATRICK S. DUFFY, MONDAY, NOVEMBER 24, 2008.

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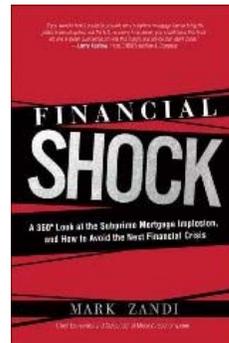
### Book Review

Title: **"Financial Shock: A 360-degree look at the subprime mortgage implosion, and how to avoid the next financial crisis."**

Author: Mark Zandi

Publisher: FT Press, 270 pages,

\$24.99



When Mark Zandi, chief economist and co-founder of Moody's Economy.com, decided to write a book on the implosion of the subprime mortgage industry earlier this year, the global meltdown in the financial markets and impact to the overall economy had yet to surface. Yet because the book is so comprehensive, it still provides an excellent framework from which to understand the root causes of the crisis, from the mistakes made by Alan Greenspan to the rapid rise of irresponsible lenders who rewrote the rules of underwriting based on their own short-term interests.

And let's not forget a compliant political system and the home buyers eager to join the ranks of owners despite any potential long-term consequences of poor financial decisions.

Beginning with a chapter that explains just how subprime mortgages evolved, Zandi writes in plain English and manages to weave a story with its share of heroes-turned-villains, including politicians pushing for an "ownership society"; a Federal Reserve chairman enamored with deregulation; an enormous amount of global money in search of a big return; financial alchemists getting drunk on their own supposed genius; home builders who ignored the lessons of the past; and bond ratings agencies who kept the entire machine humming because the profits were simply too large to pass up.

Like a party bus careening out of control, it began to experience mechanical problems in the spring of 2006, as the bag of accounting tricks offered by mortgage lenders to increasingly suspect borrowers emptied out. The bus hit the wall a year later as mortgage payments reset and defaults began to soar. Lenders were suddenly unwilling to take on the risk of refinancing subprime borrowers, no matter how high the potential income from fees rose. Given the speed at which the bus was traveling and the lack of an adequate braking system, when the end came it was not just a housing bust but a shock to the entire financial system.

So now that we're in the midst of unraveling and deleveraging the system of subprime mortgages, complex securities and credit default swaps, how do we

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prevent a repeat of this ugly scenario? Fortunately, Zandi provides his own 10-step program of policies to address a host of issues: from tossing out shady brokers to providing basic financial education in high schools across the country. These steps include the following:

1. Adopt a voluntary mortgage write-down plan
2. Establish clear mortgage lending rules
3. License all mortgage brokers
4. Expand data collection by the government
5. Reform the fractured foreclosure process
6. Invest in financial literacy starting in high school
7. Modify mark-to-market accounting when price discovery is unreliable
8. Raise financial transparency and accounting
9. Overhaul and simplify financial regulation
10. Pay attention to asset bubbles and act accordingly

In an interview, Zandi said that recent government intervention in the financial markets and sending out stimulus checks are necessary tools to support the economy, and he supports write-downs on the value of mortgages to prevent foreclosures. "It's a reasonable way to go to write down the first mortgage to the point that it becomes affordable," he says, "and guarantee the part that's written down to lenders."

As for the state of the U.S. economy, Zandi is forecasting some tough times over the next couple of years. "I think we've been in a recession for a year and will be in one through next summer -- about the worst we've experienced since World War II, perhaps not as bad as the 1982 downturn," he says. "(The) unemployment rate will probably peak at 8 percent by early 2010."

Although Dr. Zandi is pleased that many of the policy steps he suggests in his book have already been implemented, he also acknowledges that continuous and nimble government intervention is crucial. "If we don't go down this path quickly, then the policy will get overwhelmed by the magnitude of the problem."

For the nation's home builders, Zandi sees an industry that is still undergoing wrenching change and will likely emerge with a handful of big public builders rather than the patchwork of smaller private builders that has long defined the market. "I would expect to see more failures -- the big public builders are still in business and I don't think that's going to change," he said. "At the peak we were at 2 million (starts) per year, and at 1 million I don't see how we're going to navigate through that."

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