April 1, 2010

Roots of the Financial Crisis

What really happened to create the meltdown the markets experienced? Who is to blame? Theories differ, but they seem to include most of these common culprits.

- housing bubble
- sub-prime lending
- poor corporate governance
- failure of government regulations and mandates
- explicit corruption
- irrational leverage

Two themes stand out. First of all, persistently low rates encourage borrowing by all – homeowners, businesses, and government alike. Secondly, those investing in fixed income securities feel pressure to take on increased risk in order to maximize profits and cash flow.

This bubble of easy credit caused many to be overconfident that "good times" would last forever. This led to errors in judgment such as those outlined below.

Behavior of	**Erroneous Thinking**
Homeowners	• Real estate values will continue to increase linearly. • Utilizing some of my home's equity to buy discretionary items is a prudent use of money.
Real Estate Agents	• High real estate prices will continue their march upward. • Demand for home ownership will be steady. • Attractive loans will continue to be available for my clients.
Banks/Lenders	• There is an unending supply of capital available. • Aggressive lending will turn into profits. • There is always room to increase our leverage.
Ratings Agencies	• Conflict of interest was prevalent. Giving bad ratings would cause them to lose clients. • Assumed easy credit far into the future.
GSE's (Fannie/Freddie)	• Government encouraged lending to all, regardless of creditworthiness. • Implicit guarantees by the government were assumed.
Government Regulators	• Failed to investigate small firm risk (i.e. Madoff) • Failed to address systemic risk inherent in the "too-big-to-fail" firms

The government stepped in to put faith back into our financial system, guaranteeing deposits at failing banks. Now they must act to severely punish unethical corporate behavior and curtail excessive risk-taking in the financial sector. Although deleveraging our system will take several more years, signs of an economic recovery are already evident. The American people are resilient and we will learn to challenge our own assumptions in order to avoid the next crisis!

Rachel Wakefield, CFA