SIMPSON Capital Management

Strategy Perspective

Volume XII, August 2012

Great Recession Housing Bust and Financial Crisis Explained

Popular belief holds the financial crisis was attributed to *an absence of regulation*; but the root cause of the mess can be traced to moral hazards created by *systemic regulatory overreach*.

From a timing perspective, the housing bust started about eighteen months before the financial crisis. This crisis caused liquidity, the lubricant of the economy, to dry up.

To prevent a 'run on the bank', the seminal moral hazard was cast in the 30s via federal deposit insurance. It relieved the banker's need to handle deposits in a prudent manner.

The SEC and state regulators mandated shareholder capital be kept in minimum rated investments (including AAA mortgages) to provide a cushion against aggressive lending tactics.

Congress encouraged wider US homeownership by passing the Community Reinvestment Act. The Act obligated bankers to lend to lower income citizens at the expense of business loans.

HUD quotas set for these mortgages resulted in diminished down-payment and income requirements for sub-prime and Alt 'A' loans.

In 1975, the SEC conferred a legal monopoly to three credit rating firms (S&P, Moody's and Fitch). This Act eliminated the need for these firms to compete and keep their rating models current with changing times. Their erroneous AAA ratings provided seeds for the disaster.

THERE WERE NO EASY ANSWERS TO THE FINANCIAL CRISIS FOR PUBLIC POLICY-MAKERS SUCH AS BEN BERNANKE, FED CHIEF

International bankers established favorable risk weights for mortgages and mortgage-backed securities (MBS) in the Basel Accords. These policies compelled banks to hold higher than normal levels of MBS, increasing risk.

Accounting regulators changed the rules for valuing securities held on their books by requiring securities such as MBS to be 'marked to market'. This treatment triggered a bank capital squeeze when subprime MBS prices plummeted.

The result impaired bank capital and plunged the funds banks could lend out to below levels required for conducting the nation's business on a sustainable basis. Business failures and layoffs ensued and the rest is history.

Popular Myths Finger the Bankers and Other Demons

Conventional wisdom has several theories for the crisis depending on one's ideological frame of mind and need to find fault with individuals.

Pundits espouse the theory that compensation systems used by banks encouraged bankers to bet huge sums of money on continuation of the housing boom.

However, the bankers were compensated with bank stock which vested only after a period of time. This would not incentivize them to take short-term risks known to fail. In addition, reputational risk is key to a successful executive's long-term career.

Or, the reason bankers knowingly took risky bets is that they also "know" they would be bailed out if the bets went sour because they were too big to fail.

Had this been the case, the bankers would have levered their bets to the legal maximum and stocked up on the high-yielding lower tranches of the MBS rather than the low-yield AAA tranches and even lower yielding agency bonds.

It's felt the repeal of the Glass-Steagall Act of 1933 which separated depositor funds in the traditional commercial bank area from the riskier activities of investment banking contributed to the crisis.

The repealing legislation of the Gramm-Leach-Biley Act of 1999 still prohibits mixing the activities by requiring banks to conduct business in separate units under a bank holding company. The stand-alone investment firms without commercial banking, Bear Stearns and Lehman Brothers, were the ones who went bad.

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