Title
Who Created the Financial Crisis and How Do We Prevent the Next One?

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More Years of Economic Stress

- Current crisis is caused by the collapse of the biggest credit bubble in modern US history
- Growth will restart when the credit system is reasonably repaired
- Growth will restart more slowly than after past recessions

We Borrowed More Than Ever Before

Total Domestic Nonfinancial Debt as a % of GDP

Source: Ned Davis Research, 1/14/09
We cleverly packaged all this debt into leveraged structures.

Loans → Pools → Sliced and Repackaged → Waterfall of Tranches

With a balance sheet:
Assets
Liabilities
Loans
Debt
Investor
Equity

Then margin calls collapsed the value of securities, their holders and their originators.

Margin Calls → Losses on Mortgages → More Margin Calls → Collapse of Banks, Funds → Meltdown → Falling Prices of Assets → Sale of Good Assets → More Margin Calls

Lower Prices of Assets → More Asset Sales → More Margin Calls

Citigroup (CITI)
Bear Stearns
Lehman
Merrill
AIG
Bereft of Capital, Banks Tightened Lending and Pushed the Economy into Deep Recession

Securitization Provided More Credit than Banks: The Market for Securitized Debt Has Evaporated
Recession Creates “Real Credit Losses” on Top of Loss of Value in Securities, and Makes the Situation Worse

All the Advanced Economies Face Prolonged Recession

Chart 8: G4 GDP (% Annual)

Source: Capital Economic Outlook, Thomson Datastream, Bloomberg LP
Growth Will Restart When the Credit System Is Repaired

2009
Many More Losses
- Residential Mortgages
- Commercial Real Estate
- Highly Leveraged Companies
- Consumer Debt

Further Capital Erosion

2010 ?
Rebuilding Capital
- Steep Yield Curve
- Massive Government Cash Infusions
- Stabilization of Institutional Buyers

More Capital and More Willingness to Buy Securities

2011 ?
Rebuilding Confidence
- Growth, Demand and Profits Rise
- Perceived Fall in Credit Risks
- Rebuilding of Underwriting Capacity
- Domestic Savings Seeking Returns

Revived Global Securities and Lending Markets

It Will Start Off More Slowly than After Past Recessions

- US consumer demand will be muted because savings rates must rise and stay up
- As a result, much of our consumption infrastructure is redundant and must be “repurposed”
- The other side of this coin is the need to “repurpose” the production focus of our key suppliers, like China
- And we face an “echo crisis” in 2012-2014 as boom-time loans come up for renewal
... Savings Have to Increase to Historical Levels to Repay Debt and Fund Retirement

The chart shows the personal savings rate from 1960 to 2008, with a significant downward trend after 2000. The y-axis represents the savings rate as a percentage of personal disposable income, and the x-axis represents the years from 1960 to 2008.

Source: BEA, CreditSights

Fall in Share of Consumption in US Requires Economic Refocus

- 60%-65% ↔ 70%-75% ↔ 60%-65%

- Need 10%-15% LESS
  - Retail space
  - Retail employees
  - Retail delivery & support systems

- Need 25% MORE
  - Infrastructure
  - Business investment
  - Government activity

- Of course this redirection constitutes a grand investment opportunity
China Grew by Exporting Consumption Goods to Us: Now What?

China GDP Mix

And the Credit Problems Will Have an Echo

2006 & 2007 Issued US Leverage Finance Peak Maturity ($billion)

Sources: Thomson One, Credit Sights
Disclosures

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Who Created the Financial Crisis And How Do We Prevent the Next One?

By George Feiger

All parties are nominating scapegoats. Free-marketers say that government pushed agencies and originators to give mortgages to the non-creditworthy and kept interest rates too low for too long. Liberals counter that regulation was inadequate and oversight was lax. Congress and much of the public blame greedy bankers, redecorating their offices with $15,000 commodes while the system tanked.

The greed theory is clearly irrelevant. Wall Street has always had greedy people, as indeed has Congress. Interest rates have gone up and down in real and in nominal terms, and governments have favored various constituencies since governments were invented without automatically triggering a global financial crisis.

Moreover, pretty much everyone involved in the current crisis – the bankers, the regulators, members of the Congress and the Executive branch – were and are intelligent, highly educated people. Venal or not, they certainly didn’t intend to promote a disaster. The titans of Wall Street were heavily invested in their own stock and lost staggering fortunes. Tens of thousands of lesser lights have lost their jobs and most of their savings.

We have experienced failure of a system, not failures by specific people. To fix things we need to change the system not just the people. Luckily, while the needed changes are fundamental, they are, at root, quite simple. We need to reform the structures of the participating companies and of the legal and regulatory processes within which they work. We must change the incentives both of the employees of the companies and of their regulatory overseers.

Business Structure

The financial corporations that led our debacle are very large, typically multi-national but always multi-business-line investment and commercial banks. All the key entities are common-stock companies owned by a variety of institutional and individual shareholders. There are two key problems with this.

Vast, complex, publicly traded financial businesses cannot work.

No top management team can understand and effectively manage its full spectrum of activity and risk-taking: corporate finance advice, underwriting and distribution of complex securities, asset management, credit-card lending, mortgage banking, property and casualty insurance, life insurance and more. Who can understand how these interact when the institution is exposed to a business cycle? We have been here before, many times but on a smaller scale. For example, Barings Bank fell victim to Nick Leeson’s
fraud because its management of corporate financiers didn’t realize that the supposed arbitrage-based earnings of its equities department were implausibly large.

Because management can’t understand enough personally, they rely on mathematical risk models. But of course the modelers can no more comprehend the breadth than can the management. They try to infer the nature of credit risk from statistical series on losses and recoveries, but records are made to be broken, in finance as in sport. Recent “extreme” events have been large enough to wipe out the profits of a decade or two of apparently successful speculative dealing. Public company accounting produces equally worthless numbers.

Accountants report quarterly and annual results. Yet, the business cycle, sadly, runs on its own schedule. This is the meaning of the infamous remark by former Citi CEO Chuck Prince that you have to dance as long as the music is playing. Had a bank pulled in its horns, it would have shown poor calendar measures of performance, its management would have been replaced and its best employees would have jumped ship to other entities still willing to gamble. Regulators also prefer the calendar to the economic cycle when they assess the adequacy of loss reserves and capital.

*Entities in which groups of professionals make complex decisions with implications not evident for years are not well suited to public ownership.*

Investment banks, asset management firms and private equity and venture firms used to be run by private partnerships, as indeed were commercial banks in an earlier era. Partners who bore the long-term risks of their decisions were famously prudent with their capital and their compensation, not least to non-partners.

This prudential ownership structure ended when it became advantageous to deploy large amounts of capital to expand inventory holding of securities, to support proprietary trading and to bridge and otherwise facilitate merger transactions. The profits from advice were leveraged with the equity of others, and the return on the equity as a whole was leveraged with the debt of others.

Deploying capital in this way creates moral hazard because of the one-way nature of the bet. A good gamble creates fortunes. In a bad one, well, jobs are lost but mainly the money of others is lost. It also creates systemic risk because entities bloated to enormous size on leverage become too important to the credit processes of the economy to be allowed to fail.

**Regulatory Structure**

Look past the escalating calls for more and better regulation to recognize that financial services are already one of the most regulated industries in the world. Regulators are limited in effectiveness because they have the same problems of the top management of a banking conglomerate while being several steps further removed.
The regulators can no more understand the full risks and opportunities of a Citi than can the management. One regulator handles broker/dealers, another commercial banks, another insurance and so on. Separate, they struggle over regulatory turf; together in some super-agency, they would be in a somewhat worse position than those people in Citi’s board room who couldn’t see the hurricane that was about to hit them.

Their situation is made worse by lack of money. They can afford neither the brilliant fat-cats sitting in the investment banks nor their analytical data and tools. Today’s mood is to pay bankers less than the President, not to pay the bureaucrats as much as the brokers.

**Business Incentives**

Combining calendar-year success-based compensation in public companies with the long-tailed consequences of business actions has unfortunate consequences.

Business choices in these complex entities are very difficult to evaluate from the outside. Investors, counterparties and regulators must rely on the top management to make all key decisions, not least the design and operation of the incentive system.

Once outside the private partnership world, the equilibrium state of the incentive system will be permanently unfavorable to stability. Incentives with long lock-ups will fail because another firm will offer a shorter lock-up for the “best performers,” another one will counter and so on. That is why, in the middle of the greatest collapse of equity values in decades, successful stockbrokers are being promised multi-year guaranteed compensation if they move to a competitor. Subject the whole industry to pressure to limit compensation and new industries are created like private equity and hedge funds.

**Regulatory Incentives**

Here we need to acknowledge some unpleasant realities.

Regulators are never thanked for the things that don’t go wrong, but if a problem arises the search for the guilty starts with them. There is a strong incentive for regulators to resist all change in case it creates unanticipated problems and thereby slows down all progress. And these are the accusations hurled at all regulators by the regulated. The consequence is to discredit the regulators in the eyes of public and government in those long quiet periods when they seem to be nothing but an obstacle. Then the big broker/dealers can convince Congress to increase their leverage from 12 to 30 because it will facilitate some grand public purpose like underwriting more mortgage securities.

Regulators are as ambitious as the rest of us. Work as an SEC attorney for a while and you are likely to be hired by a big Wall Street firm to handle its regulatory relations. Thinking ahead, as ambitious and capable people do, it would be best not to excessively alienate your future employers.
While these realities are deeply entwined in our economic and political system, there are completely feasible steps we can take that will materially lower the risk of our financial system. We need to simplify and limit the size of the players; cap leverage; and, to the extent possible, take the key risk-taking entities out of public ownership and back to private partnerships.

**Cap size.** There may be economies of scale in production and “one stop” convenience for customers. However, the diseconomies of complexity and systemic risk clearly outweigh these benefits. First, we need to break up multi-industry businesses along the lines of Glass-Steagall. Then, of equal importance, we need to cap market share by line of business in order to keep the players below “systemic risk” size.

**Cap leverage.** However bad an idea is, leverage makes it worse because it makes it bigger. We can go a long way to enhancing stability if we simply limit explicit leverage allowed to the now-smaller and more focused financial market players that we would create.

**Return the risk taking to ownership by partners.** Only partners have the long-term incentive to create thoughtful approaches to risk taking while being close enough to the risks to understand them. Not all financial businesses can be partnerships. But we can try to reinstate mutual ownership of exchanges and private ownership of all entities entitled to provide opinion letters on valuations or due diligence on underwritings. We can try to do the same with ownership of rating agencies. We should explore introducing these “incentive blockers” in as many places as we can.

*George Feiger is Chief Executive Officer of Contango Capital Advisors, the wealth management arm of Zions Bancorporation. The opinions expressed in this article are Mr. Feiger’s and not necessarily those of Contango or Zions.*

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