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Risk Comes Home to Roost: The U.S. Financial Crisis

Current upheaval among U.S. financial institutions is the result of a build-up of excess leverage in financial markets. The deleveraging now underway will likely result in a period of slower economic growth. Caution remains imperative as market volatility is likely to continue and further detrimental events are possible. Given the current low valuations, any sign of stabilization in the housing market or economic recovery could trigger gains in both equity and credit markets.

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The Event

We have seen the bailout of the U.S. government backed mortgage financiers, Fannie Mae and Freddie Mac, the chapter 11 bankruptcy filing of Lehman Bros., the takeover of Merrill Lynch by Bank of America, the U.S. Federal Reserve bailout of insurance giant AIG and the plummeting stock prices in a number of other financial companies. These events are truly extraordinary and have significantly shaken the confidence of investors. Investors must now decide: is the economy fundamentally sound or do these events portend years of disruption and poor growth?

The Background

The current crisis is the result of a combination of factors that have been in place for several years, all of which resulted in an overleveraging of many companies and individuals. Low interest rates throughout the mid years of this decade encouraged savers to seek higher yielding debt instruments; higher yields were found by lending to lower quality borrowers at higher interest rates (sub-prime mortgages for example); securitization of these debt instruments (supposedly) diversified away the risk of lower quality debtors by pooling the debt; the risks were further cut (supposedly) by investing in real estate, which, in modern history, had not fallen in price nationally; overly aggressive mortgage brokers unencumbered by prudent oversight and controls sought out lower and lower quality borrowers, lower collateral levels and less documentation of income status.

Much of this process was carried out by less regulated financial companies rather than more highly regulated commercial banks. Less regulated companies were able to leverage their assets at much higher rates. Little capital was put at risk by those companies originating the loans or by those companies securitizing the loans. Those companies did not hold the assets and therefore did not have sufficient interest in assuring the quality of the assets backing the securitized loans.

The buyers of the securitized loans were guilty of believing they could receive higher interest rates without assuming higher risk. The ratings agencies aided the misperception by rating securities higher than, in retrospect, they should have been rated. This cycle of originating more and more loans of lower and lower quality continued for several years as real estate prices rose.

Throughout these years, default insurance on this debt could be bought from monoline insurers or by buying credit default swaps from companies such as AIG. Such insurance was better in theory than in reality as most companies that offered it sold so much that if defaults rose, the insurers were probably not going to be able to pay.

Let's now fast-forward to late summer 2008. Real estate prices are now off 19% from their highs and suddenly large numbers of loans are in default and securitized debt prices are falling precipitously.

Each of the financial companies mentioned at the beginning of this piece was involved in some way in the origination, selling or buying of securitized debt. Each company was insufficiently regulated and highly levered.

For each company, the process by which their over-levered balance sheet unwound was different, yet the same. Securitized loans used as collateral fell in price, requiring more collateral. Rating agencies downgraded debt, which also led to an increase in collateral calls. The dollar amounts were large and the need to raise large amounts of capital pressured the companies to sell assets if possible.

As the companies continue to struggle, investors have become more reluctant to step in and provide equity. For Lehman and Merrill, this meant they were forced to put themselves up for sale. For AIG, it means the announced Fed bailout.

The Outlook

Some of the long-term implications for financial companies and for the economy in general are clear. We are going to go through a lengthy period of deleveraging. Furthermore, the era of ever-growing disintermediation has ended. Far fewer loans will be securitized; Wall Street firms will have a stake in the assets they sell; capital requirements will be higher; and regulation will be tighter. These actions will favor those financial institutions that are better managed, have larger capital bases and have not relied heavily on securitization in recent years. In the current environment, capital adequacy and near-term access to capital will be the key to survival. Companies that can raise comparatively cheap capital through retail banking channels are likely to be the winners, as are the stronger financial companies that have high credit ratings and are able to maintain those ratings. These are the companies that will likely increase market share under the new business model for financial companies – a model that will look a lot like the model that existed up until about ten years ago.

The implication for the economy of a period of deleveraging is for slower economic growth. During the last period of deleveraging in the early 1990's, there was a recession in the U.S. Yet over that entire period of deleveraging, the U.S. still managed to average over 2% GDP growth.[1]

Clearly the financial markets have priced in some degree of tough times ahead. Through September 15th, the S&P 500 is off 24% from its October 2007 high. Further volatility is likely, but there could be significant upside given any signs of stabilization of the housing market or signs the economy's growth rate is about to recover. Valuations across all credit and mortgage sectors are at historically wide premiums and also represent tremendous value upon market stabilization.

The recent events emphasize that the crisis isn't over. Issues from the U.S. housing market, the root of the cause, continue to impact financial institutions. In the short term, there is also some contagion risk due to the high interconnectivity within the financial system and, by extension, across other sectors of the economy.

There are however, signs that the situation may be improving: housing price declines have slowed since the summer from earlier rates of decline; the volume of existing homes for sale has stabilized at 5 million, or 11 months of supply[2]; and recent declines in mortgage rates help make houses more affordable.

[1]MFC Global Investment Management
[2]National Association of Realtors