Recent Crisis: Roots and Lessons

by Stephen Mitchell and John F. McGarry

Risk management lessons abound from the current crisis. Understanding the lessons requires a clear assessment of the roots of the crisis. A simplified assessment of the underpinnings of the crisis sheds light on pivotal mistakes and offers valuable learnings.

Roots

The roots of the crisis are understood, on a simplified basis, by three L's:

- Lack of accountability
- Leverage
- Liquidity

Lack of accountability is most evident in the fundamental changes in the mortgage market in recent historical periods.

Historically, people requiring mortgages sought their mortgages from local institutions that would conduct the evaluation and hold the risk. Loan officers of these institutions were accountable for the outcomes of their decisions—defaults were a direct reflection on their judgment. In recent periods, mortgage originators abound. In this model, the originators create the mortgage and then send it to other institutions for holding. Originators are compensated on the volume of mortgages created, but are not impacted by the end outcome relative to default.

Historically, people sought mortgages to buy a primary residence—the clear intent being long-term occupancy. In recent times, based on a protracted period of increasing property values, people sought mortgages to fund investment properties. "Flipping houses" has become a popular income and investment strategy, as well as a national past time. As a leveraged investment financing vehicle, mortgages create an updated set of "walk away" rules. While people do not vacate their primary residences in periods of property value declines, investors will abandon their interest ("turn in the keys") when the investment does not produce value. Walking away is rational economic behavior given the altered nature of the interest of the property and the use of the mortgage.

The impacts of these changes in the fundamentals of the mortgage market were further magnified by expansion of mortgage availability with regard to terms (e.g., interest-only payment patterns, less money down) and creditworthiness of applicants.

Leverage was a second key factor. Institutions guaranteed mortgages against default. Based on historical experience, only small amounts of money, typically measured in terms of basis points, were required by the companies accepting this risk. This left institutions exposed to guaranteeing large sums of money based on comparatively little income.

There were two primary problems with this approach. First, many of the institutions failed to evaluate the potential risk and hold reserves or capital against any material differences from historical default rates and patterns. Second, insuring institutions often failed to recognize the changing dynamics noted above and the conditions they created for significantly increased default risk in the event of a downturn in property values.

When the first two L's came together, the third L, liquidity, became a problem. When property values eventually evidenced their inevitable fall, defaults occurred at historically high rates. This led those institutions that had assumed the risk, potentially without appropriate capitalization, to have large and immediate cash needs. Those with cash held onto it, while those without it sold what they could—pressuring values—and borrowed what little they could at high cost. A crisis of liquidity emerged.

Lessons

Separating authority and accountability seldom results in responsible outcomes. Whenever decision-making is divorced from accountability of outcomes, there is often not enough "skin in the game" to create incentives necessary for parties to expect rational behavior, or at least not to expect historically experienced behavior. When fundamental changes in the mortgage market changed the interest of originators and the "walk away" rules of mortgage holders, the change in accountability had profound results.

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The lesson of accountability has continued applicability in many areas. We should continue to be on guard for elements of the financial markets that may not evidence a crisp relation between authority and accountability. We should also look at our own organizations and institutions to be sure that the individuals we rely on for decisions in sales, service, management and professional ranks have the interest in the outcomes necessary to drive rational behavior.

Secondly, it is a refreshed truism for us from the crisis that nothing lasts forever. Markets can begin to behave as if a trend, such as increasing housing values, will go on forever. Any system that is geared to function only when values or trends move in one direction is surely doomed to failure.

As we step into the future, we need to be on guard for any system of business or financial strategies or behaviors that is based on the fundamental tenet that a certain trend will continue indefinitely. The best strategies are both resilient under a variety of circumstances and adaptable to change.

Focusing on fundamentals never goes out of style. The evaluation of defaults was guided by history. An evaluation of the changes sweeping the origination of the mortgages and the profile of their holders should have revealed a different picture. Institutions that should have been expert at managing financial risk failed to fairly assess and provide provision for adversity.

Looking through assessments provided by others and constantly challenging our understanding of the dynamics around us is critical. In a world of increasing volumes of collateralized securities and derivatives, it is hugely important to look beyond the wrappers to the base assets and behaviors. The sum may indeed be different than its parts.

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