

## The Financial Crises: A Ripple Effect of Incentivised Disorder

by Paul Conlin

The current financial crisis is the result of the interplay of changing circumstances, since the 1970s, on Main Street, Wall Street and internationally.

On Main Street, savings and lending used to occur locally. There's the classic scene from "It's a Wonderful Life" where the depositors of a local S&L demand their savings back from the bank manager, played by Jimmy Stewart. He says, correctly, that he can't give them their money back because he doesn't have it—it's invested in the homes of their neighbors. In the world portrayed by the movie, lending standards were monitored by local lending officers in the communities—lending never got too loose, since the S&Ls would have to eat the losses; or too tight, since no loans would happen. And when blow-ups did occur, as in Texas in the 1980s oil glut, they tended to be contained locally. But the S&L crisis of the 1980s destroyed the local savings institutions and ushered in the era of interstate financial conglomerates that borrow funds, short term, from the worldwide credit markets.

On Wall Street, the investment banks were partnerships. When the Wall Street firms underwrote a deal or traded securities, it was the personal wealth of the partners on the line, so solvency was highly incented. During the 1970s, the partnership ownership structure constrained growth of the Wall Street firms and caused capital shortages. Donaldson Lufkin Jenrette filed for public ownership in 1969, and the stock market boom of 1982–2000 caused most of the others to follow. With shareholders putting a premium on earnings growth and return on equity, the Wall Street firms increased leverage and risk. They had no margin of error for the wave of credit defaults, which were to begin in 2007.

Finally, internationally, the lapse of the Bretton Woods monetary system in 1973 and free float of currencies allowed the United States, the highest currency on the food chain, to sustain massive budget and trade deficits. Devel-

oping economies (first Japan, then Korea/Singapore/Hong Kong and finally China/India) adopted protectionist/capitalist strategies similar to what the United States adopted in the 1800s. But unlike the American consumer, the consumer of these export-led economies never switched from a savings- to a consumption-based lifestyle. Even in now-developed Japan, consumers save a substantial portion of their income. So the large surpluses in the world continue to recycle back into the United States, including disproportionately (thanks to the implied, and after Sept. 8, 2008, the official, government backing of Fannie Mae and Freddie Mac) into American housing.

The world of the local S&Ls, the partner-owned investment bank and Bretton Woods isn't coming back. So what does that leave us to do next? Part of me is persuaded by the second law of thermodynamics, which says that existence gets progressively more and more disordered with the passage of time, since any work done to address the current crisis expends more energy and causes more disorder than it fixes.

On the other hand, we need to at least try something. The lending of money by \$500-per-year Chinese factory workers to Americans to buy \$250,000 houses strikes me as the best place to start. A home mortgage should not be able to be securitized. If this makes it more difficult for Americans to borrow for homes, so be it—the true economic costs (and risks) of such loans must be reflected in mortgage rates, and the ripple effect must be felt in home prices. There is an insurance precedent for this—a primary insurer can transfer risk to a reinsurer, but always remains on the hook if the reinsurer defaults. A mortgage loan must be a permanent arrangement between the lender and borrower—if this is not acceptable to either, no problem: no deal. Legislation and regulation codifying such a (seemingly, by comparison to current rules) draconian regime must be enacted while the consequences of the alternative are fresh.

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