The Rennie Quarterly Return

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What Really Happened, i.e., How to Build the Next Financial Crisis

The world has been awash in explanations for the current financial crisis. Banks, politicians, mortgage lenders, Wall Street, investors and mortgagees all seem to have differing views—views which change often. Is it any wonder that the public is confused? Is it any wonder that those directly involved are confused? We think not. Not surprisingly, all fingers of blame point outward.

We think a pragmatic analysis of what really happened may be helpful. So, we'll take our shot.

Many have pointed at the 1977 Community Reinvestment Act as genesis of our current crisis. It required banks to meet the needs of the communities they served, i.e., to provide loans to people of moderate to low incomes. Certainly, banks should be able to absorb the additional risk of such loans if small relative to their balance sheets. However, over the years, pressures from many sides caused the volume of such loans to balloon. Economic activity increased. Everyone was happy.

Prospering greatly and sensing no imminent problems with all of this additional risk, banks and mortgage lenders gradually expanded lending to just about anybody for any reason. Recall the NINJA loan, no income, no job, no assets, no problem. And why not! After all, lenders never held these loans. They quickly sold them to Fannie Mae, Freddie Mac or Wall Street firms who packaged them into mortgage backed securities which were then sold throughout the world. And why were they so easy to sell? Because the rating agencies gave them the highest AAA rating, meaning that they were indeed about the safest kind of security one could own.

How about the little people who took out all of those mortgages knowing that they probably could not pay? What was their motivation? We see three possibles.

First were the "flippers," the short-term buyers who believed that any property could be sold easily and quickly at a profit--then on to another property, another sale, another profit. Unfortunately, trees don't grow to the sky. Eventually, the house of cards collapsed.

Second were some who were duped by real estate salespeople eager to make sales, mortgage lenders eager to lend, appraisers eager to accommodate, and "don't worry, you can make it" assurances from all. It is a sad and painful day when reality can no longer be denied.

Third were the optimists who really wanted to take a shot at realizing their dream, and own that house on the hill—even if it meant two jobs, overtime and whatever else it would take. Sometimes life smiles on them; sometimes it doesn't.

Therefore, the little people certainly played a big role in the crisis, being either over-optimistic or snookered.

What single act could/should have precluded the crisis? We think it's simple—lenders did not maintain time-tested lending standards.

There are reams of existing data and untold mathematical models which already exist that predict fairly accurately the probability that a borrower will successfully pay off a loan. No new studies or data is required.

These standards were abandoned because lenders no longer had any "skin" in the game—they passed their loans to other very willing buyers. Furthermore, it was very profitable to do so. Lenders became financial pipelines making money on money going in both directions.

You would think we would learn. Remember the Savings & Loan Crisis—only the names have changed.

In our last Return, we noted Winston Churchill's quote: "Never give up! Never, Never Give up" to which we suggest adding "our lending standards."

Our thanks to former Senator Phil Gramm for several of his articles and speeches which helped crystallize our thoughts.

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Our Two 

"Men are made stronger on realization that the helping hand they need is at the end of their own arm."

Sidney J. Phillips

Quarterly Trivia:

In what year was the Federal Reserve System, "The Fed," created?

1913 (Ha, thought it was in the '30s didn't you?)