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FOCUS

Repeated cases of negligence spurred the financial crisis

Lenders, regulators failed to apply proper risk controls

GUEST COLUMN

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Real estate speculation, excess liquidity and deregulation get a lot of the blame for our current economic crisis. We never will figure out how to prevent dramatic cyclical changes in markets, and the regulatory climate will change depending on who is in office.

However, in the current crisis, the normal cycles have been needlessly magnified because those in positions of power in business, accounting and government failed to enforce existing regulations and failed to apply existing risk controls and accounting standards to prevent catastrophic failures that they knew could occur.

First, there was the risk created by increasingly novel types of securities, such as new forms of derivatives. Wall Street and many lending companies also were peddling mortgage-backed securities and other, older forms of securities in increasingly large amounts.

The bank and securities regulators and the financial institutions that were buying and selling these securities knew that the securities were not being traded in transparent markets, knew that these markets could stop trading, and knew that the securities were extremely hard to value. Yet, there was a risk of catastrophic failure because the claimed values were so large.

Those regulators also knew that the risk could have a cascading effect due to the circular nature of the financial statements of our financial institutions — if one emperor had no clothes none did because they spent their time trading the same wardrobe and claiming its high value on their financial statements.

One reason for the large declines in the Japanese stock market in the late 1980s was that major Japanese companies had large stockholdings in each other. So when one company's stock went down in value, the stock of the other companies who owned stock in the first one also went down, and the decline continued to feed upon itself.

Similarly, our banks and other financial companies own huge amounts of mortgage-backed securities and derivatives with values supposedly supported by the financial strength of other financial companies. When some financial companies start having problems, many other companies are affected because their financial statements all are based on their holdings of the other companies' mortgage-backed securities and derivatives.

In his annual report for 2002, Warren Buffet described the losses that his company, Berkshire Hathaway, incurred from the derivatives held by an insurance subsidiary after it liquidated the derivatives in what was then an orderly market. Buffet said: "No matter how financially sophisticated you are, you can't possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions."

The market for just one type of derivative grew 40 times since 2002. The swaps, which basically are credit insurance, have now been sold on $55 trillion to $60 trillion in loans. The growth in this high finance swap meet was known from data published by the aptly named International Swaps and Derivatives Association. Yet, the regulators and buyers of credit default swaps made reckless assumptions about the financial strength of the sellers of those derivatives — insurance only works if the insurer has money — and ignored the risk that obligations inherent in credit default swaps imposed on the firms that were selling them, such as AIG, which recently cratered.

A second case of responsible parties failing to apply existing risk controls and accounting standards revolves around the risks associated with the financial models being used to value derivatives. These risks were made dramatically evident in 1998 with the demise of the short-lived Long Term Capital Management. Wall Street and derivative traders knew from that fiasco and other failures that risk models failed to give sufficient weight to the effect of potential catastrophic market conditions or pyramiding failures.

The risks associated with mortgage-backed securities became evident by at least 2001 with the demise of several companies that issued such securities. These companies included Southern Pacific Funding Corp., which, while not related to the railroad, jumped the tracks right here in Portland. The regulators, accountants and financial industry risk managers knew from that experience that mortgage-backed securities are very difficult to value and are subject to fraud in the loan application process, which gives incentive to mortgage brokers and borrowers to act improperly.

Third, there was the issue of mark-to-the-market accounting or, in reality, the lack thereof.

Some people say that making companies value risky or novel securities on their financial statements at market value is unfair because the market values of mortgage-backed securities and derivatives can be lower than their "real" value.

But the real issue is why the companies and their regulators and auditors put any value at all on these securities when they knew that the values were so hard to determine and when they knew that the valuation models were not reliable. If banks and securities firms had been forced to value these assets properly, they never would have acquired them because they would immediately have been placed on the balance sheet at a value well below the original cost.

Fourth, buyers of mortgage-backed securities and other debt-based securities knew from the Enron debacle and related events that the bond rating agencies often tell us that a debtor is having problems just before it goes bankrupt — Moody's is often the last to go into a funk. Yet, buyers assumed that debt had AAA ratings when they did not understand the securities or the ratings process.

National Public Radio recently ran a story about the chairman of the largest bank in Spain. He said: "If you don't fully understand an instrument, don't buy it. If you will not buy for yourself a specific product, don't try to sell it. If you don't know very well your customers, don't lend them any money."

If other business leaders and government officials had acted as responsibly, we would be in much better shape today.

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