Global Financial Crisis …a refreshing perspective!

Last week, a prominent American journalist, Bill Moyers, interviewed John S. Reed, the former CEO of Citicorp and Citigroup. It was broadcast as part of a television series about the cause of the global financial crisis that began in late 2007.

I was especially pleased, and felt a little pride, having worked under Reed's leadership, that he could bring such a holistic view to the scenario. The message that Moyers was trying to deliver was a fairly common one. To me, John Reed's answers were more meaningful, and showed his understanding that the crisis was caused by a lack of common sense, greed fostered by weak regulation, and ignorance of some very basic lessons of lending and credit. It was really refreshing to see and hear a respected banker be honest about what happened in the nineties and noughties, and his views on how he and his industry peers played a part.

Moyers makes a strong case, particularly in his fundamental premise… that the crisis was caused by the reversal of the US Glass- Steagall act, which had separated US investment banking and commercial banking since the 1930's. John Reed subtly points out that the elimination of Glass-Steagall may have made the problem worse, but that it was not the cause of the crisis.

John Reed believes that "the iceberg would have been hit" regardless, due to the fact that banks and mortgage brokers were making loans that made no sense whatsoever. He also admitted that his MIT colleagues (he is Chairman of the Board of Trustees of The Mass Institute of Technology, MIT), must also share some of the blame because their models allowed bank executives to believe that all risks could be identified and managed.

So, the crisis might have been contained, if banks had not been following risk management models that somehow ignored the fundamental risks that were being generated. Billions of dollars of mortgage securities defaulted due to ignorance of a fundamental lesson of banking - don't lend unless you understand how you are going to be paid back!

Mr Reed acknowledges that individual home mortgage loans were being made in the United States with little regard to the ability of the borrower to repay the loan. Through the non- bank market, many of these loans were initiated out of regulatory oversight by independent mortgage brokers and sold to investment banks which then securitized the loans and sold them to investors in the form of fixed income securities. Common sense was ignored, partly due to the assumption that residential real estate values never fell, and that the borrowers would sell or refinance before they ran out of money to make their mortgage payments. This aspect of the crisis was caused by terrible lending practices, with little or no regulatory oversight. Apparently the investors that purchased the mortgage securities, and the rating agencies that reviewed them, didn't carefully examine the loan underwriting standards.

What was the cause of the crisis? In my view, the key points from this interview were:

1. It was ignorance of the fact that the risk of "something going wrong" in the mortgage securities market, was much larger than anyone seemed to realize.
2. It was the fact that bankers, rating agencies, and regulators didn't understand that a huge proportion of the mortgage loans being made were flawed or would deteriorate over time.
3. US regulators did not enforce basic lending standards, both within and outside of the banking system.
4. The problem was further exacerbated by the creation and distribution of these mortgage loans via securitization.

But the elimination of the Glass-Steagall Act would not have averted this crisis, although it may have added fuel to the fire.

To watch the full interview click here. Please email info@consultancymatters.com to let me know what you think of it and my "take" on the key points that arose!

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