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Editorial

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The Financial Services Industry Through the Great Recession and Beyond

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The financial services industry has undergone tremendous changes in the last decade. As the 2000's began, the world of professional finance was undergoing a major transition into large scale trading of mortgage-backed securities. This transition was facilitated by technological innovations which allowed for the repackaging and trading of portfolios of mortgages, as well as by substantial cash inflows into the US from savers abroad. This growth trajectory was generally impressive until late 2006 to early 2007, despite minor stumbles in the recession of 2001, and the slowdown in 2003.

As we entered the late winter of 2006, red lights began flashing in some lesser known mortgage lenders, mostly dealing with mortgages from northern California and Nevada. The default rate on such mortgages began creeping up from less than half a percent, to one percent and eventually to three percent.

The reasons for this remarkable, and unprecedented, jump in homeowners defaulting on their mortgages and losing their homes are varied. But foremost among the drivers of this phenomenon was the fact that loan officers were generally compensated on the basis of loan volume. That is, the more loans approved, the higher the loan officer's salary. This provided an incentive for loan officers to say yes to any applicant they could.

Additionally, this laxity of lending standard was abetted by government sponsored entities such as Fannie Mae and Freddie Mac, which at the behest of the Federal Government were complicit in encouraging banks to view homeownership as a right.

Ultimately, this situation was untenable. It was only a matter of time until loans being offered to poor credit risks started to default at unusually high rates. This led to a large number of foreclosed and repossessed homes coming on the market. And this, in turn, led to a widespread decrease in home values.

As home prices fell, more and more homeowners mortgages became underwater (meaning their debt was higher than the value of the house) and this led to yet more defaults, and the cycle continued. Prices spiraled downwards, and continued to do so for several years. It was only in 2012 and 2013 that the housing market has finally begun to stabilize.

Unfortunately, the stabilization of the mortgage market was not entirely organic. In large part it is due to the fact that the Federal Reserve has been supporting the market by buying mortgage-backed securities, thus encouraging lenders to lend.

Unfortunately, this kind of massive, multibillion dollar per month purchases by the Federal Reserve –known as quantitative easing -- raises the question: how does this end? The Federal Reserve cannot continue to do this forever, because if they did, the Fed's balance sheet would grow to infinity.

The immediate conclusion is that the Fed will eventually have to stop buying mortgages, and the Fed has said as much. When this happens, mortgage interest rates will inevitably shoot up. It is only a question of time.

A slow transition into normalcy may be possible, and is certainly desirable. However, as of this writing in the spring of 2013, we have the additional problem that the stock market, and the bond market, is incredibly elevated. A small correction to housing prices may therefore translate into a wider correction in asset prices, the stock market, and bond prices. Regulators and the investing public need to be very mindful of this situation and exercise great caution in terms of their appetite for risk going forward.

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