The 10 Lessons for Policymakers from the Financial Crisis

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by Larry Swedroe

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The 10th anniversary of the Great Financial Crisis is the subject of lots of articles and media coverage. As a result, I've been getting many questions about what caused that crisis and the lessons we can take away to prepare for the inevitable next one.

I'll begin with a brief review of the main causes. (Entire books have been written on the subject.) Unfortunately, while the media often focuses on the failure of financial models, the real causes can be found elsewhere.

The origins of the crisis

The origin of the crisis stemmed from the political objective of increasing home ownership, beginning with FDR and including Reagan, Clinton and George W. Bush. This goal was aided by the enactment of the Community Reinvestment Act (CRA) of 1977. The CRA's intent was noble – to encourage depository institutions to help meet the credit needs of the communities in which they operate and to eliminate “redlining” (not lending to anyone in certain neighborhoods) and discrimination.

Next up was the Housing and Community Development Act of 1992, which established an “affordable housing” loan purchase mandate for Fannie Mae and Freddie Mac. That mandate was to be regulated by HUD. Initially, the 1992 legislation required that 30% or more of Fannie’s and Freddie’s loan purchases be related to “affordable housing” (borrowers who were below normal lending standards). However, HUD was given the power to set future requirements, and HUD persistently increased the mandates, which encouraged “subprime” mortgages.

By 2007, the goal had reached 55%. In other words, more than half the loans originated were “affordable housing” loans. Like many well-intentioned ideas, they failed to anticipate the unintended consequences, especially when taken to an extreme.

In this case, the goals went too far, with required down payments dropping from 20% to 10% to 5%, then 3% and eventually to 0%. And Fannie Mae and Freddie Mac (backed by an implied government guarantee) were operating with very high amounts of leverage while making these now-very-risky loans.

Another related contributing factor was that in 1995, Fannie Mae and Freddie Mac introduced automated underwriting systems, designed to speed up the underwriting process and approve more loans. These systems, which soon set underwriting standards for most of the industry (whether or not the loans were purchased by the government sponsored entities), greatly relaxed the underwriting standards.

Then we had the 1999 repeal of the Glass Steagall Act, which led to the separation of investment banks and commercial banks. On top of that, we had the failure of the bank regulators to address the issue of depository banks moving risky assets and their associated liabilities off-balance sheet via so-called special purpose vehicles. This allowed the banks to remove those amounts from the capital requirements computation, allowing them to take on more risk.

Additional factors

Following is a short list of the other major issues that added fuel to the fire that was simmering, and without which the crisis could never have become the conflagration it did. It was a total failure of regulators across the system.

a) Appraisals were massively fraudulent, with a total failure of state and local regulators in the mortgage industry to...
actually do their jobs and prevent those frauds – the problem wasn’t the lack of regulation but the failure of regulators to do what they were paid to do.

b) Financial institutions severely over-leveraged, and regulations favored housing loans for bank capital standards. Because government policies favored housing, bank capital requirements were much lower for mortgages than for other risk assets. Again, it was a failure of regulators – in this case the Federal Reserve, which oversees the banking industry – to do their job, allowing banks to park assets offshore and not hold sufficient capital given the riskiness of those assets.

c) An often-overlooked cause was the conversion of private investment banks to public companies. That changed the nature of risk-taking at the institutions, which were no longer just investing their own personal capital but that of shareholders and lenders as well. That created a potential misalignment of interests. When they were private companies, the leverage of these banks tended to be in the low single digits. However, once they went public, leverage not only jumped into double digits (while much riskier assets were taken on at the same time), but some were leveraging at more than 20 and 30 to 1. Regulators had oversight of these investment banks and could have prevented that increased leverage. Yet they did nothing. The problem was so large, that by 2007, the five top investment banks had more than $4 trillion in debt, roughly 30% of the size of the U.S. economy.

One more part of the story is often overlooked. It’s the “agency problem” (misalignment of interests) created by allowing the ratings agencies (Moody’s, S&P, Fitch) to have the originators of product pay for the ratings instead of the buyers who rely on the ratings.

This isn’t an issue when dealing with municipal bonds or corporations since neither will typically borrow more to invest in projects if their rating is higher than it should be. However, with asset-backed securities, which depend on having high investment-grade ratings (AAA/AA) to be able to find buyers, AAA/AA ratings will allow for more origination.

By providing higher ratings than were justified by the risks, the ratings agencies could collect more fees, and the investment banks would originate more and earn greater profits. And many employees of the ratings agencies ended up working for the investment banks that helped them work “the system.”

The relative importance of the contributors to the crisis

Summarizing, powerful incentives played a role in building up to the crisis. Mortgage bankers made money no matter the credit or interest rate risks. They underwrote to the standards set by Fannie and Freddie and VA, which were persistently pushed to make terms looser.

Then, incented by fees to originators, there were massive frauds on appraisals that the regulators failed to even address. Investment banks had incentives to buy and package the junk mortgages and sell them to the public. Rating agencies made more money as they approved what was junk and found ways to call it AAA or AA. And finally, regulators totally failed to do their jobs.

These were the causes of the Great Financial Crisis, not the poorly designed models used by the agencies and banks to justify the positions they were taking. In other words, models are only as good as the assumptions used in them. If you base models on sound financial theory and very long periods of time that demonstrate persistence and pervasiveness of the evidence, you can have some degree of confidence that the models reflect reality, or at least a reasonable approximation. On the other hand, if there is no theory, nor evidence to support the model, it’s worse than worthless, because you are relying on the output to make decisions.

The poor models would not have mattered if the underlying causes did not exist. They were just enablers, not underlying causes.

A good example of this were models that assumed that real estate never goes down, so “flat” was a “worst case scenario.” One can only assume that those using a model with that type of assumption had never heard of the Great Depression.

Unaddressed problems

Unfortunately, many of the problems discussed above have not been corrected, which means a repeat is possible, if not likely. While bank capital standards have been raised, we still have banks that are too big to fail.

The solution to that is simple: As banks get larger, require more capital. For example, for each incremental $10 billion of assets, the equity capital requirement could be 1% higher. Eventually, equity capital would be too costly. Another option is
to require that bank debt be converted to equity if the bank’s capital ratio falls below a certain level.

These are simple solutions that don’t require regulations that stifle business, innovation and the economy in ways that the Dodd-Frank Act did. For example, since the enactment of that bill, almost no small banks have been started in the U.S. And small banks make most of the loans to small businesses, which in turn create most of the new jobs.

That contributed to the slowest economic recovery the U.S. has experienced, without a single year of 3% growth in GNP in the eight succeeding years. It’s hard to argue that’s a coincidence, because historically, the steeper the recession, the stronger the recovery.

Sadly, nothing in that bill addressed the real issues behind the crisis – certainly not the too-big-to-fail problem, as banks have become much larger as the increased costs of regulation lead to the need for economies of scale and ever larger banks. And we still have the problem of the ratings agencies being paid by originators of asset-backed securities, not the buyers. That should be changed.

Now let’s consider what investors should have learned from that crisis.

Lessons learned

Here’s my list of 10 important lessons the crisis taught investors:

1. It was a reminder to never treat the unlikely as impossible and that severe bear markets can and do happen. It’s why, when designing your investment policy statement, you need to be sure your allocation to risky assets does not exceed your ability, willingness or need to take risk (see “The Only Guide You’ll Ever Need for the Right Financial Plan: Managing Your Wealth, Risk, and Investments”). And while we were lucky that stocks began their recovery in March 2009, it’s important to understand that bear markets can last a lot longer. Thus, an investment plan should incorporate the potential for extended bear markets, like the kind Japan experienced after the Nikkei Index peaked at 38,916 on Dec. 29, 1989. It finally reached its low of 7,054 on March 10, 2009. And at about 23,400 (its level on Sept. 18, 2018), it is still down about 40% from its peak almost 29 years later.

2. Overconfidence is an all-too-human trait. Being overconfident about your risk tolerance can be costly, because the easiest person to fool is yourself. Investors who had less risk tolerance than they thought pre-crisis were forced to re-evaluate their willingness to take risk. This may have caused them to engage in panic selling, totally abandoning equities, or at the very least, move to a more conservative allocation during the crisis. Note that correcting a mistake is better than perpetuating it, as there was no guarantee the crisis would end favorably.

3. Global diversification of equity risks won’t help you when you have systemic risks that impact the entire global economy in similar ways. During such times, the correlation of risky assets jumps toward 1. Unfortunately, many investors take the wrong lesson from that, thinking it means they don’t need to include international equities in their portfolio. However, that’s the wrong conclusion. While correlations do tend to rise sharply in crises, they tend to revert to longer-term averages over time. Thus, they provide diversification benefits over the long term. In addition, global diversification also helps when there are “disasters” that are idiosyncratic to one country (such as Japan’s bubble bursting in 1989) – and diversification is a free lunch for helping in those cases.

4. The right lesson is to be sure you have a sufficient amount of safe (not risky) fixed-income assets in your portfolio, an amount sufficient to dampen the risk of the overall portfolio to an acceptable level. And be sure you are not overconfident about your ability and willingness to take risk.

5. Sticking to your well-thought-out plan is critically important during times of market turmoil. Investors who abandoned their plan and lowered, or even eliminated, their equity allocation have had significantly lower returns than those who stuck to their plan.

6. A traditional portfolio whose risk is dominated by market beta – like a 60/40 portfolio – doesn’t have 60% of its risk in stocks, but closer to 90%. That’s because stocks are about four or five times more volatile than an intermediate-term Treasury bond, and why typical 60/40 portfolios can experience severe drawdowns in bear markets.

7. The main role of fixed income in a portfolio should be to dampen the risk of the overall portfolio to an acceptable level. Thus, it’s important that your fixed-income assets don’t introduce equity-like risk through the backdoor. In 2008, while five-year Treasuries returned +13.1%, the Bloomberg Barclays US High Yield Bond Index Intermediate returned –25.5%. Even if you stuck to investment-grade corporates, the FTSE US Broad Investment-Grade Corporate Bond Index A 3-7 Years returned –4.8% in 2008. If you took on even more credit risk, Vanguard’s High-Yield Corporate Fund Investor Shares (VWEHX), according to Morningstar data, returned –21.3%.

8. A focus by investors on a cash-flow approach to investing can lead them to consider using dividend-paying stocks or REITs as alternatives to safe bonds. Both of these alternatives have significant equity risk. Morningstar data show that, in 2008, the Vanguard High Dividend Yield ETF (VYM) returned -32.1%, and the Vanguard Real Estate ETF (VNQ) returned -37.1%. Such losses could have caused the overall portfolio loss to exceed an investor’s risk tolerance.
9. A strategy that has historically reduced the risk of those severe drawdowns has been to build a portfolio with lower exposure to equities but higher than market exposure to the small and value stocks that have historically provided higher returns. That’s the strategy discussed in detail in “Reducing the Risk of Black Swans: Using the Science of Investing to Capture Returns with Less Volatility 2018 edition.” The holding of higher expected returning assets allows you to hold more safe bonds. Along with the increased exposure to the size and value factors (which have historically had low correlation to market beta), the greater exposure to safe bonds allows you to create more of a risk parity strategy, avoiding the concentration risk of more traditional portfolios. And since markets are highly efficient, all risky assets should provide similar risk-adjusted returns.

10. Financial innovation in the form of interval funds has provided investors with additional unique sources of risk and return which they can access – risks that reduce the concentration risk of traditional portfolios and thus reduce drawdown risk. The vehicles that my firm recommends are Stone Ridge Alternative Lending Risk Premium Fund (LENDX), Stone Ridge Reinsurance Risk Premium Interval Fund (SRRIX) and Stone Ridge All Asset Variance Risk Premium Fund (AVRPX). In addition, my firm recommends AQR’s Style Premia Alternative (QSPRX) and Alternative Risk Premia (QRPRX) funds, as they too provide exposure to unique sources of risk and return that provide diversification benefits that reduce drawdown risk. We typically recommend that investors consider allocating 10-25% of their portfolio to these assets. And the more conservative the investor, the more these should be considered for their diversification and tail-hedging properties. These strategies and their benefits are discussed in the aforementioned 2018 edition of “Reducing the Risk of Black Swans.” (Full disclosure: My firm, Buckingham Strategic Wealth, recommends Stone Ridge and AQR funds in constructing client portfolios.)

One of my favorite expressions is that even smart people make mistakes. What differentiates them from fools is that they learn from their mistakes and don’t repeat them. Battles are won in the preparatory stage, not on the battlefield where emotions can lead to mistakes.

Hopefully, the above lessons will help you develop an investment policy statement that will allow you to weather the next crisis with equanimity, to sleep well and to enjoy your life while you adhere to that well-thought-out plan that anticipated a future crisis.

Larry Swedroe is the director of research for The BAM Alliance, a community of more than 140 independent registered investment advisors throughout the country.