Angelides Preliminary Outline on Findings and Conclusions Regarding the Causes of and Contributors to the Financial and Economic Crisis

Phillip Angelides
Findings and Conclusions Regarding the Causes of and Contributors to the Financial and Economic Crisis

Specific Findings

- There were Dramatic Failures of Corporate Management and Governance
  - Management and Governance:
    - Many systemically important financial institutions, including investment banks, commercial banks, and the GSEs, acted recklessly, exposing their companies to significant losses and, in most cases, failure or rescue by American taxpayers.
  - Risk Management:
    - Failures included excessive leverage/inadequate capital, insufficient liquidity including high reliance on “hot money”, highly risky activities, non-transparent off balance sheet risks, and inadequate management systems and controls. These various factors, as well as compensation practices (see below), were interconnected and must be viewed in toto.
  - Compensation:
    - Compensation structures and scale created incentives to increase annual revenues and market share, without properly taking into account risks, long term performance, and consequences of loss or failure.
  - Risky, Complex Securities:
    - Major financial institutions put their companies and the financial system at risk through their trading in the untested, complex non-prime mortgage related securities that triggered the financial crisis (see below).
    - Among other things, they supported/owned subprime lenders; securitized such securities without proper due diligence and disclosure; created derivative instruments (e.g. synthetic CDOs) that increased leverage and amplified exposure to mortgage assets; and ended up retaining significant such assets on their balance sheets which, in turn, led to substantial losses.
    - At the investment banks, these activities were part of a larger shift from privately held entities focused on investment banking to publicly
traded corporations highly focused on trading and principal investments.

- Lack of Market Discipline and Regulation:
  - The failures in corporate risk management were particularly important in light of the increased reliance on self–regulation (see below). Faith in the ability of financial institutions and markets to regulate themselves turned out to be misplaced.
  - The lack of market discipline coupled with lack of effective supervision and regulatory gaps was fatal.

- There Were Significant Failures in Public Sector Leadership, Regulation, and Supervision

  - Failure to Use Substantial Powers:
    - Policy makers and regulators failed to use their substantial, existing powers to protect the financial system and the public. They had broad authority to constrain risky financial products and financial institution risks and excess.
    - Time and time again, the regulators were behind the curve as dangers mounted – outrun and outmatched by Wall Street and market events.
    - Notably, the Fed Reserve, along with other regulators, failed to curb the precipitous decline in mortgage credit standards. As other examples, regulators failed to constrain leverage, effectively oversee off balance sheet entities, and police short term funding by institutions.

  - Regulatory Gaps and Arbitrage:
    - Regulatory gaps – including regulatory arbitrage - resulted in a lack of transparency in critical markets. Regulator shopping resulted in weakened supervision through entities such as the OTS and the SEC’s CSE program.
    - These gaps resulted from a failure to keep up with the evolving financial system or deliberate decisions to deregulate or lessen regulatory requirements. In addition, regulators failed to ask for needed authority in areas where they did not have it, but where they identified risks.

  - Derivatives:
    - The decision to ban regulation of OTC derivatives played a critical role in the crisis. The lack of regulation resulted in a lack of transparency, excess speculation, increased leverage, non-transparent counterparty risk, and an absence of business conduct rules. In addition, it precluded state regulators (e.g. NY state insurance regulator) from acting.
    - Among other things, credit derivatives facilitated and extended the duration of subprime securitization, helped fuel the housing bubble, increased the leverage of financial institutions, and amplified exposure to the mortgage market.
The lack of transparency of OTC derivatives and the substantial interconnections between systemically important institutions resulting from those derivatives played a key role in the panic of 2008.

- **Deregulation:**
  - The failures in regulation and supervision were in part due to a broadly accepted philosophy – embodied in policy and practice and endorsed by the elected leadership of both parties – that called for a greater reliance on self regulation of financial markets and institutions.
  - Even when regulators sought authority (CFTC, OFHEO), they were rebuffed.
  - As noted above, the combination of weakened regulation and supervision and poor corporate risk management proved devastating.

- **Power of the Financial Industry:**
  - The financial industry exerted substantial power and pressure and undertook extensive lobbying efforts to affect legislation and relax regulation, contributing significantly to weakened oversight.

- **The Housing Boom and Bust Triggered the Financial Crisis**

  - **Declining Mortgage Standards Were Central:**
    - Dramatically and rapidly declining mortgage underwriting standards significantly enlarged the housing bubble and bust.
    - The explosion of poor quality, non-prime loans resulted in unprecedented delinquency and foreclosure rates which triggered a wave of events that ultimately resulted in the financial and economic crisis.
    - Bank regulators were generally not worried about mortgage origination standards since banks were selling loans into the secondary market (see mortgage regulation below).
  
  - **Failure of Mortgage Regulation:**
    - Regulators failed to halt worsening underwriting standards. While federal and state regulators share in the culpability to varying degrees, prime responsibility rests with the Federal Reserve that had the ability under HOEPA to regulate unfair and deceptive lending and inappropriate subprime lending.
    - The lack of any real effective regulation, coupled with incentives such as yield spread premiums, led to a corruption of the mortgage sector, opening the door to predatory lending, fraud, misrepresentation, and other inappropriate lending.

  - **Non-Prime Mortgage Securitization:**
    - Non-prime mortgage securitization was essential to the origination of the burgeoning numbers of subprime and Alt A loans.
    - System incentives (“no skin in the game”) and the assumption that assets would be moved along the chain/off the books contributed to the creation and sale of increasingly poor quality mortgages.
- Mortgage securities were packaged and sold without appropriate due diligence and disclosures to investors.
- As noted above, credit derivatives were an essential component of the subprime and Alt A securitization process.

  o **Credit Rating Agency Failures:**
    - The credit rating agencies were essential to non-prime mortgage securitization and, thus the non-prime mortgage origination business. Their failure to assess the quality of the securities which they rated was seminal to the crisis.
    - But for the rating agencies, the subprime lending and securitization could not have occurred on a significant scale.

  o **GSEs:**
    - The GSEs contributed to, but were not a primary cause of the financial crisis. Their scale mattered and they were dramatic failures, with a deeply flawed business model.
    - They added significant demand for less-than-prime loans – but they followed, rather than led the Wall Street firms. The delinquency rates on the subprime and Alt A loans that they purchased were significantly lower than those purchased by Wall Street firms.
    - They dramatically increased their subprime and Alt participation in the 2005-2007 period primarily to regain market share, but also to a lesser extent to meet affordable housing goals.
    - They utilized their political power to successfully resist effective regulation.

  o **Government Housing Policy:**
    - HUD’s affordable housing goals resulted in the GSEs buying more high risk mortgages at the margin.
    - There was no evidence in the Commission’s inquiry indicating that the Community Reinvestment Act contributed to the crisis.
    - The government’s aggressive promotion of homeownership provided cover for the expansion of inappropriate subprime lending (n.b. - homeownership stopped climbing in 2004 and much of the subprime lending activity was for refinancing, not home purchase - let alone first time home purchase).
    - Policy makers failed to ensure that their stated homeownership policy goals were being carried out by sound and sustainable practices on the ground - even community based groups advocating increased homeownership were sounding the alarm over lending practices.

- **Excess Leverage, Risk, and Speculation Fueled the Crisis**
  - **Inadequate Capital:**
    - High leverage/inadequate capital made many financial institutions (e.g. GSEs, investment banks) extraordinarily vulnerable to the downturn in the market. Leverage or capital inadequacy at many institutions was even greater than reported when taking into account
“window dressing”, off balance sheet exposures (e.g. Citigroup) and derivatives positions (e.g. AIG).

- When mortgage assets and derivatives began to plummet in value beginning in 2007, many institutions came under enormous financial pressure given their thin capital margins.

**“Hot Money”:**
- The financial system, particularly the “shadow banking” system, was extraordinary dependent on “hot money” including short term (including overnight) commercial paper and repo funding.
- When lenders began to have concerns about the health of certain financial institutions, initially growing out of concerns re their exposure to troubled mortgage related assets, they began to shorten the duration of lending or pull back from lending. As concerns accelerated, liquidity shrank, and questions grew re the financial condition of certain institutions (see transparency below), runs began at institutions.
- Runs even affected some insured depository institutions (e.g. Indy Mac, Wachovia)

**Risk and Speculation:**
- The increase in risky, complex, and often non-transparent financial products and activities contributed to the vulnerability of firms and the system as a whole. Trading –including proprietary trading – replaced traditional investment banking as the largest source of revenue at investment banks and a sizable source of revenues at traditional banks.
- Dealing in derivatives had grown exponentially, particularly by systemically important institutions. In the case of synthetic CDOs, these were almost infinitely levered speculative instruments that amplified exposure to default prone mortgages and mortgage securities.
- The combination of high leverage, reliance on “hot money” and risky and complex financial products was an explosive mix.

**Too Big to Fail:**
- Many creditors of large systemically institutions did not exercise discipline when extending credit to such institutions on the assumption that the government would intervene to protect creditors in the event of the potential failure of such institutions.

- Lack of Transparency and Interconnections Spurred Panic during the Crisis

**Lack of Transparency:**
- The lack of transparency about the financial condition of various systemically important institutions and their counterparties exacerbated the panic and the financial crisis of 2008. This lack of transparency was due to both decisions by firms re: structuring and disclosure and lack of regulatory requirements re: disclosure.
As firms scrambled to get a handle on their own exposures, counterparties and regulators struggled to understand, among other things, the nature and extent of mortgage related holdings, derivative positions, and the cash position of those firms. The lack of knowledge and transparency resulted in panic.

- **Interconnections:**
  - The extensive interconnections between major financial institutions through a variety of markets and instruments – including the repo market, interbank lending, and OTC derivatives – and the scale and concentration of those exposures (e.g. Fed analyses of Lehman and AIG) were seminal to the crisis. The interconnections – coupled with the lack of transparency – caused panic.

**Broad, Overarching Findings**

- **The Crisis Was Avoidable**
  - **Public and Private Sector Leadership Failures:**
    - Financial institution leaders failed in the prudent management of their companies.
    - Public leaders and regulators had extensive powers, yet failed to protect the financial system, the economy, and the public from the crisis.
    - If timely and appropriate actions had been taken, the crisis could have been avoided, or at least significantly mitigated.
  - **Warning Signs Ignored:**
    - Numerous warning signs were ignored in the years leading up to the crisis and even after the housing market began to peak and decline in 2005 and 2006.
  - **Excess Liquidity and Government Policy:**
    - Significant cash –including cash from abroad - seeking to invest in real estate assets was a necessary pre-condition for the crisis.
    - The Fed and other regulators did not take the actions necessary to constrain the credit bubble.
    - The Fed’s policies and pronouncements encouraged the growth of mortgage debt and the housing bubble.
  - **Complacency/Lack of Due Care:**
    - There was a complacency and lack of due care on the part of too many policy makers, regulators, and others (e.g. economists, households) due to a “conventional wisdom” that the business cycles had been mastered (the Great Moderation), financial risk had been quantified and tamed, and financial crises could be handled (the Greenspan Put).
    - Policy makers and regulators did not understand or appreciate the growing risks to the financial system.
Slow and Inconsistent Government Response:
- The government’s response to the crisis itself in 2006-2008 was flat footed at first and then inconsistent, exacerbating the crisis.
- The inadequacy of the policy makers’ and regulators’ response to the crisis left the nation in the fall of 2008 with only two stark choices: potential collapse of the financial system or the infusion of trillions of taxpayer dollars.
- The inconsistent response worsened the crisis: policy makers saved Bear, placed Fannie and Freddie in conservatorship, and then failed to save Lehman.

There was a Breakdown in Accountability, Responsibility, and Ethics

Tone at the Top:
- Primary responsibility for the breakdown rests with those in charge – tone at the top mattered.

Ethical Responsibilities:
- Too many companies and individuals created and/or sold financial products without regard to the quality of those products, the conflicts in their activities and the consequences to the larger financial system and economy.

Broad Responsibility:
- As the speculative fever took hold, too many people participated in activities that proved to be detrimental to their firms, their clients, their households, and the ultimately the financial system and the economy.
- Too many households and companies took on more debt than they could afford. Some households that took on debt were misled, steered into inappropriate debt, or did not have the needed financial literacy.

Accountability and Critical Analysis:
- Faith in our financial system has been shaken. The economic consequences of the crisis have been profound. Yet, there has been little acceptance of responsibility by many financial industry and public sector leaders who were at the center of this crisis. The lack of critical self examination – a prerequisite for change – has been striking.
- There have been few people held to account and little or no consequence for inappropriate actions.

The crisis and risks remain with us

The Crisis Persists:
- The country remains in the grips of a severe economic crisis. Unemployment is high. Foreclosures continue to climb, while many families are running into a brick wall as they try to modify mortgages.
Future economic security has been diminished for tens of millions of Americans.

- While government actions taken in the fall of 2008 and early 2009 may have stabilized financial markets and major financial institutions, they did not spare the real economy from deep pain. The consequences of the financial crisis of 2007-2008 are likely to be felt for a generation.

  - **The Future of Financial Reform Uncertain:**
    - The financial reform legislation of 2010 will be largely shaped by some 250 rule making procedures and the outcome of those proceedings is very much up in the air. In addition, no action has been taken on critical issues such as the future of Fannie Mae and Freddie Mac.
    - Real reform will require changes beyond legislation - in, among other things, corporate governance, compensation incentives, and risk management as well as standards of ethics and corporate responsibility.

  - **The Risks of Future Crisis:**
    - There are fewer, bigger systemically important financial institutions now than were before the crisis.
    - While the banks have returned to profitability – largely through borrowing cheaply and making money on the spread, there are still significant risks including a still struggling housing sector, significant commercial real estate exposures, and the lack of systemic reform.
    - Very little real change has yet occurred.