11-2-2011

A Tale Of Leverage and Hubris

John H. Brown

Follow this and additional works at: http://digitalcommons.georgiasouthern.edu/savannah

Recommended Citation

This article is brought to you for free and open access by the College of Business Administration Publications at Digital Commons@Georgia Southern. It has been accepted for inclusion in Business in Savannah Articles by an authorized administrator of Digital Commons@Georgia Southern. For more information, please contact digitalcommons@georgiasouthern.edu.
A tale of leverage and hubris

As the financial crisis of 2008 fades into history, most people have remained confused about the causes of this economic tsunami. Since the nature of the train wreck goes a long way towards explaining the present stagnation of the U.S. economy, this is unfortunate.

A large part of the confusion lies in the partisan wrangling about the roots of the crisis. Bethany McLean and Joe Nocera have written the most balanced and comprehensive account of the evolution of this cataclysm.

The starting point is the idea of financial leverage, simple in concept, if often complex in implementation.

In finance you use leverage by purchasing an asset with borrowed funds. The advantage is more of the asset can be purchased and any gains in the asset’s value go to the buyer.

This credit risk is at the core of all lending decisions. Lenders protect themselves from credit risk in three ways:

First, they try to only lend to borrowers who will repay the loan. (credit evaluation) However, even the most careful lender will make mistakes, so lenders backstop themselves with two added protections. The try not to lend too much to any one borrower (diversification), and they don’t commit every possible dollar to lending (capital reserves).

Each of these has a role in the story of the financial crisis.

Let us start with capital reserves. Lenders know they need to maintain the safety margins capital reserves represent. However, the reserves do not earn anything, so there is a continuing pressure to use capital reserves.

One of the lessons of the Great Depression was that lenders tempted by profits do not keep adequate capital. So, since the 1930s lenders have been required by law to maintain certain minimum levels of reserves.

This results in continual gaming of the legal capital requirements.

One method of reducing required capital is to demonstrate the risks of your lending are low. If your loans as a group are mostly unrelated, then diversification means you are less at risk than a lender with an equal amount of money loaned to very similar borrowers.

Traditional mortgage lenders usually made their loans to borrowers in a single geographic area where an unfortunate event (say a plant closing) could cause lots of defaults. By bundling mortgages from many areas in the country, diversification was achieved and risks lowered.

However, something important was lost.

Local lenders had both the ability and the incentive to judge the creditworthiness of borrowers. When loans began to be made on a national basis, both of these were lost. There was a replacement available in the form of the national credit rating agencies. However, their incentives were thoroughly perverted by the gusher of money unleashed by mortgage securitization.

Beyond this, practices were embraced in the name of diversification that had no relationship to actually reducing the risks of lending. In particular, the process of creating new securities by bundling poor credit risks from several distinct sources resulted in increased risks since these securities were even more likely to default.

In effect, all of the traditional protections against bad lending were forfeited in the rush to exploit the phony diversification of securitization. McLean and Nocera lay this all out in painstaking detail. They also do so without the partisan axe grinding that characterizes so much that has been written on this subject.

It’s highly recommended reading.

Dr. John H. Brown is an associate professor in the School of Economic Development at Georgia Southern University. Dr. Brown can be reached at jbrown@georgiasouthern.edu.


BiS EAGLE EXECUTIVE BRIEFINGS | COMMUNITY

Parker honored as ‘innovator’

BUSINESS IN SAVANNAH

Parker’s convenience stores’ tech-savvy approach to its business has led to a food service industry trade publication to name the company’s president and CEO, Greg Parker, as convenience store “Innovator of the Year” for the southeast region.

The Griffin Report of Food Marketing picked the Savannah businessman because of his “unique take on operating practices such as product selection, inventory and management,” according to spokesman Mike Berger.

A feature on Parker will appear in a future issue of the publication.

Another trade publication, Convenience Store Petroleum, or CSP for short, profiled Parker recently, dubbing him the “Profit Prophet.” The piece examines how his 21 area convenience stores consistently rank among the nation’s most profitable, according to National Association of Convenience Stores data.

“We’re doing a lot of new stuff, and I’m honored by the recognition,” Parker said. “We really are innovative. We’re doing things that nobody else is doing.”

Adam Van Brimmer

Parker

BiS EAGLE EXECUTIVE BRIEFINGS | COMMUNITY

Contact Membership Director Vernice Rackett 912.450.2288
vrackett@troongolf.com

www.SavannahQuartersCC.com

Coastal Georgia’s business community lives, works, and plays at Savannah Quarters Country Club.

Memberships available as low as $2,000

Contact Membership Director Vernice Rackett 912.450.2288
vrackett@troongolf.com

www.SavannahQuartersCC.com