The 2009 Financial Crisis: A Golden Opportunity

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You can't turn on your computer, radio or television these days without being assaulted by bad news about the economy. Another victim laid by the way-side, shot dead by enormous financial losses, lack of available credit, or sell-off panic on the part of investors. It seems as if there is no safe place to turn, and no one is immune from this insatiable predator.

But for anyone who is in business to actually run a business, this is an age of golden opportunity.

What? you ask. 'Has she lost her mind?'

Let me start by giving some background on how we ended up in this mess. Once upon a time, financial institutions lent money to individuals and businesses, based upon assets owned, credit-worthiness, and cash flows. These financial institutions were your partner for the long-haul. They knew you. They worked with you. They held your loan until maturity. Ah, the glory days.

Then along came this phenomenon called Securitization. Why should these banks bear all of the risk of loan defaults? The banks could make more money, and lessen their exposure, by packing up these loans as investments, and selling them to other banks, hedge funds and investors. The idea being that by pooling the loan assets, the risk of any single loan defaulting is mitigated by other loans in the portfolio, and the overall risk is shifted to the investor in the pool, rather than the original underwriter of the loan. What a great idea!

Then in 1997, a group of investment bankers came up with another great idea. They called it 'Credit Default Swaps (CDS)', a sophisticated credit derivative contract that could be bought & sold, like any other security. In simple terms, a CDS operates like an insurance contract. An investor, or buyer, purchases a CDS against a particular debt obligation of a corporation or sovereign government, and pays a 'premium' to the financial institution, or seller. In return, the buyer receives a payoff if the underlying debt instrument defaults. Sounds simple, right? Here's an extra little twist: the buyer never has to own the underlying debt obligation to begin with. Meaning, there were a lot of investors out there just buying CDSs, betting that the credit-worthiness of a particular company would decline, and thereby collecting millions of dollars in 'insurance' and reporting enormous financial gains (capital gains, I might add). Another little twist: CDSs are investment vehicles, not insurance, so no one was regulating them. Meaning, unlike insurance, which requires that the insurance company have the financial wherewithal to pay claims, there is no regulator overseeing the CDS market, and CDS contracts are entered into based on private negotiation and faith that the seller will have the resources to pay the claim later down the road. So what happens when CDS contracts are also being sold on those financial institutions who are themselves the underwriters in these transactions? **Lehman Brothers bankruptcy.**

Let's turn for a moment to the scapegoat of the current crisis: the U.S. housing market. Back in 2001-2002, the Federal Reserve lowered interest rates in an effort to spur the economy post 9/11, and encourage home ownership. As debt became cheaper, companies and individuals alike began tapping into this debt as an inexpensive means to fund expansions, acquisitions, leveraged buy-outs, capital spending, vacations… the list goes on and on. By 2007, the average American was spending more than 120% of his income, and corporations were no better. Zero percent financing sound familiar? No money down? This cheap financing quickly found its way to the housing market, as the commercial banks wanted to capitalize on the growth in loan underwriting that FANNIE MAE and FREDDIE MAC were experiencing, with higher risk borrowers. And since loans were so cheap and easy to get, everyone wanted in, which drove home prices higher and higher. Best of all, with Securitization and the invention of Mortgage Backed Securities (MBS), the banks didn't have to bear the risk of loan defaults and foreclosures, meaning they could relax their lending standards, drop their interest rate spread, and even create risky new products to sell, such as interest only loans. Everyone won! The real estate developers & agents, the mortgage brokers, the banks, the investors (or so they thought) – everyone along the chain was making a profit, and the global capital markets couldn't get enough of MBSs. Of course, this Ponzi scheme was built on the assumption that interest would be forever cheap and that housing prices would never decline.

But, as with all good things, this too came to an end. In 2007, interest rates were on the rise as the Fed wanted to 'cool the economy down' to avoid inflation. As interest rates increased, variable rate loans and mortgages became more expensive, and the demand for housing started to fall. Further, those homeowners and investors who held variable rate loans saw significant increases in their monthly payments, and with no ability to refinance the loans into cheaper alternatives, these variable loans started going into default. This quickly snowballed, and all of those financial institutions, hedge funds, corporations and private investors around the world who held MBSs started to see significant declines in the value of the assets. With the asset values declining, their credit-worthiness also became affected, which in turn caused many investors to cash in on the CDS contracts they were holding against those banks and corporations. Imagine their surprise when the financial institutions that underwrote the CDS contracts had suffered substantial financial losses as well, and there were no assets by which to satisfy the contract. The deck of cards had fallen!

Which brings me back to my original proclamation that this is an age of golden opportunity for business. So what do I mean by that? The lessons of the last decade are bringing us back to our roots. Banks, investors, and shareholders are desperately seeking real value, not inflated returns on non-existent assets. Business schools are once again focused on teaching real business management, and not hedge fund management. The U.S. and foreign governments have taken great pains to ensure that capital is still flowing, albeit with tighter, restrictions and more appropriate interest rate spreads. Those companies that recognize and treat debt as it should be treated – as a component of the capital invested in the business –will have the advantage of stronger balance sheets and greater financing opportunities. In addition, those organizations that take the next step and manage profit as a cost of doing business will benefit even greater, as banks, investors, and employees all look for a life boat, with Titanics like GM continuing to sink around them.

No doubt that these are some of the most challenging economic times that most business managers have ever seen during their careers. But those that take the bull by the horns – instead of curling up in the fetal position praying for the next market bubble to pull them out of their financial mess – will reap the benefits of a new found financial-moral compass, with greater opportunities, stronger balance sheets, and higher profits.

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