Lesson One: What Really Lies Behind the Financial Crisis?

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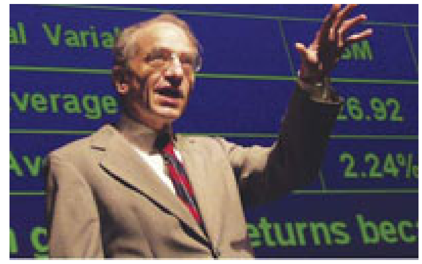

What was the true cause of the worst financial crisis the world has seen since the Great Depression? Was it excessive greed on Wall Street? Was it mark-to-market accounting? The answer is none of the above, saysJeremy Siegel, a professor of finance at Wharton. While these factors contributed to the crisis, they do not represent its most significant cause.

Here is the real reason, according to Siegel: Financial firms bought, held and insured large quantities of risky, mortgage-related assets on borrowed money. The irony is that these financial giants had little need to hold these securities; they were already making enormous profits simply from creating, bundling and selling them. "During dot-com IPOs of the early 1990s, the firms that underwrote the stock offerings did not hold on to those stocks," Siegel says. "They flipped them. But in the case of mortgage-backed securities, the financial firms decided these were good assets to hold. That was their fatal flaw."

Speaking in Philadelphia on January 20, Siegel, author of *Stocks for the Long Run* and *The Future for Investors*, provided a detailed analysis of the factors that fueled the worldwide financial meltdown. His talk was the inaugural lecture of a 15-session course on the financial crisis that Wharton is offering MBA and undergraduate students. Siegel's mission was to detail the factors that sparked the crisis that has caused the U.S. stock market to lose more than a third of its value in a year, while sending unemployment to its highest level since the 1980s. Siegel's lecture was on the same day that millions of Americans expressed optimism over the inauguration of President Barack Obama, even as the Dow plunged another 300 points.

Explaining his theory further, Siegel pointed out that many troubled banks and insurers continued to prosper in almost every other aspect of their businesses right up to the 2008 meltdown. The exception was the billions of dollars in mortgage-backed securities that they bought and held on to or insured even after U.S. home prices went into a free-fall more than two years ago. American International Group (AIG), the insurer that received an $85 billion federal rescue package last September, is a prime example. Some 95% of its business units were profitable when the company collapsed. "AIG has 125,000 employees," Siegel noted. "Basically, 80 of them tanked the firm. It was the New Products Division, which had an office in London and a small branch office in Connecticut. They came up with the idea of insuring mortgage-backed assets, and nobody at the top decided it wasn't a good idea. So they bet the house -- and the company went under."

Lapse over Lehman

According to Siegel, federal officials -- particularly outgoing Treasury Secretary Henry Paulson --- mishandled initial efforts to intervene in the crisis. For example, Paulson was concerned about the political backlash that might be unleashed by bailing out Lehman Brothers. He allowed the firm to collapse last September but underestimated the impact of Lehman's demise on financial markets. Despite a $700 billion bailout, banks are still unwilling to extend credit, Siegel said.

Siegel told his student audience that in many important measures, the economy is not nearly as battered as it was during the early 1980s, when unemployment, inflation, and interest rates were all considerably higher than they are today. Stocks -- as evaluated by their price-to-earnings ratios -- are undervalued to the point where they could draw enough investors to spark a recovery before the end of 2009. "I'm actually an optimist," said Siegel. "I think by the second half of this year, things might turn around faster than people are now predicting."

While angry investors and taxpayers are anxiously looking to assign blame for the current state of the economy, it's important to know not only which factors led to the meltdown, but which ones did not. He said that government programs encouraging home-buying by low- and middle-income families and short-selling of financial stocks -- which was halted for a time last fall -- have little to do with the crisis on Wall Street.

Instead, Siegel pointed to two interlocking issues: One is a massive failure, not only by traders, but by CEOs of financial firms, their risk management specialists and the major rating agencies to recognize that an unprecedented housing-price bubble began building after 2000. Their faulty reasoning was that the inability of homeowners to pay their mortgages -- and the consequent foreclosures -- would not pose a threat to their mortgage-backed securities. They believed that as long as home prices kept rising, the underlying value of the real estate would provide a hedge against the risk of such defaults. They failed to realize that this reasoning was based on the assumption that home prices would go in just one direction -- up. In fact, these assets became enormously risky once the housing bubble burst and home prices began their inevitable decline.

Siegel also argued that ultimately, the buck stops with corporate CEOs who didn't ask hard enough questions about the risks posed by mortgage-backed assets. He said he and others have wondered why firms like Lehman Brothers, Bear Stearns and Morgan Stanley -- which survived the much more severe Great Depression of the 1930s -- collapsed during 2008. One reason, he suggested, might be that, back then, these firms were organized as partnerships. In such an organizational structure, the partners would have to risk their own capital. When the partnerships were reorganized as widely held public companies, however, they no longer had such constraints. "Back when it was a partnership, you had your life invested in that company," said Siegel, noting that banks also began making higher-return but higher-risk investments in recent years as public ownership increased.

Greenspan's Role

One other key player that Siegel criticized for not heading off the collapse of the mortgage-backed securities is former Federal Reserve chairman Alan Greenspan, who oversaw the government's central bank until 2006. Greenspan was so influential while he oversaw the Fed that he could have easily blown the whistle on the over-accumulation of mortgage-backed assets by the U.S.-based financial giants. He, however, failed to discover that firms were taking such large, risky individual stakes without protecting themselves against a housing market collapse. "[Greenspan was] the greatest central banker in history -- he had access to every piece of data," Siegel said. "He could have looked at the balance sheets of Morgan Stanley or Citigroup and said, 'Oh my God -- they didn't neutralize their risk.'"

Another reason why federal officials and economists failed to detect the perilous economic risks of the 2000s, Siegel said, is the so-called "Great Moderation." This term refers to the fact that since the 1980s, the volatility of the business cycle has declined, thanks to more aggressive fiscal policy and the rise of a service-based economy, among other factors. Siegel noted that a similar flattening of the economic cycles had occurred during the 1920s after the 1913 establishment of the Federal Reserve Bank, a factor that caused stock investors to ignore risks, which eventually led to the stock market crash of 1929 and the Great Depression.

"People asked, 'Are we ever going to have a big recession again?'" Siegel said of today's policy makers. "Everybody thought we were in a new stage and risk premiums didn't need to be so high." But those risks hit home last year. While it would have been difficult for federal regulators to save Lehman Brothers -- which had invested billions of dollars in assets related to subprime mortgages -- even if they had acted six months sooner, the fall of the 158-year-old financial house had a disastrous impact on the wider financial market. Lehman Brothers was connected to 950,000 or so transactions. As a result, bankers became gun-shy about making any type of loan, even to companies with a flawless credit history.

Trouble with TARP

For that reason, Siegel said, the initial phase of the Bush administration's Troubled Asset Relief

Program (TARP) was seriously flawed. Paulson's Treasury Department decided to buy equity stakes in troubled banks, assuming they would make more loans with more capital on hand. The amount of capital, though, has little to do with the reluctance of banks to make loans, even as the rate on federal funds is slashed to near zero. John Maynard Keynes, the British economist, called this situation a "liquidity trap," Siegel noted. "The big failure of TARP was that it misunderstood why banks weren't lending. Officials thought it was because they didn't have enough capital. In reality, they were worried about the solvency of all the borrowing that was out there." Siegel suggested that the government rescue plan could be improved with guarantees that recipients demonstrate they are using the federal dollars to extend credit.

According to Siegel, monetary policy has failed to stimulate the U.S. economy. The U.S. faces a situation similar to what happened in Japan during the 1990s when interest rates of zero could not revive the country's moribund financial markets. The only viable solution now open to American policy makers is Keynesian fiscal policy, a stimulus program that lowers taxes or increases government spending or both. Indeed, this is exactly the type of program -- costing at least $825 billion -- that the Obama administration and Senate Democrats are considering. Siegel said that policymakers should not worry about the impact on deficits; it is large, he added, but not dangerously so.

Towards the end of his 90-minute talk, Siegel offered some tongue-in-cheek advice to would-be entrepreneurs. "Start a new bank," he said. "You won't have the problems of existing banks, and the federal loans interest rate is near zero. Demand for loans is high, and you will face no competition from the private market. You could become very profitable."