
A CREDIT MAN'S TAKE ON THE FINANCIAL MALAISE

In the first blog of a periodic series, Ed O'Leary looks at lessons credit people can learn from the financial malaise

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First of a periodic series

One question I am frequently asked these days-and probably many of you hear it, too- is: "What caused the current financial mess?"

The usual default answer from most people is "subprime mortgages." There's no doubt that figures in the mix. Another close second is "greed" or those sorts of human behaviors, showing how out-of-kilter some of our incentive compensation was in the financial services industry in recent years. Greed, fueled by incentives, belongs on any short list of causative factors.

However, the core reason may be much simpler to understand.

Seed of the crisis

There's a bit of common wisdom, virtually unchallenged until 2008, that housing prices would not collapse.

Indeed, in the lifetimes of most of us, this has never happened. There were relatively minor corrections in California in the early 1990s. Condominium prices experienced temporary softness in some markets. This was due to construction activity running temporarily ahead of long-term demand.

But not in nearly 75 years have housing prices deflated in a serious and disruptive way. Had this assumption not been so widely accepted, much of today's pain in the banking system and in the economy at large would probably have been avoided-or at least significantly abated.

How it put down roots

Here's a clear example of how that assumption, coupled with the widely held social goal of broad home ownership, combined to produce the residential real estate bubble of the last few years.

A recent article in Harper's Monthly made some interesting points about how financing of residential real estate evolved over the last two generations or so.

A 12% rate, a monthly payment of \$1,000, and a 10-year amortization schedule will support \$69,701 of original principal. On the other hand, a 30-year amortization at the same 12% and \$1,000 per month will support \$92,218 of original principal.

An interest rate of 4% and a monthly payment of \$1,000 will support original principal of \$98,770 on a 10-year amortization schedule, while a 30-year schedule at the same 4% and \$1,000 per month will support an original principal balance of \$209,461.

Both rate and amortization schedules have a bearing on home finance. But the combination of low rates and longer amortization schedules produces a very significant expansion of principal that can be repaid by that same \$1,000 per month.

What persuaded banks to start lending money for residential mortgage purposes for a period of 30 years? Ultimately, I think it's the assumption, fortified by favorable experience over the years, that housing prices would be stable to rising over time.

There's no doubt that inflationary expectations are embedded in this assumption as well.

At the end of World War II, most residential mortgages had terms of 12 to 15 years. This gradually expanded to terms of up to 30 years over the next three decades. This shift came in through the influence of government programs and favorable underwriting experiences. It also made possible the enormous growth in residential housing stock and favored large segments of our population with the opportunity to own their own homes and begin creating personal wealth through home ownership.

Fertilizing the growth

Another somewhat related factor in contributing to the housing "bubble" seems to be the availability and relative cost of credit, especially since 9-11. Rates for monetary policy purposes have been at record historical lows.

Perhaps it's human nature to think that when a borrower pays 10% for credit, compared to 5%, the money is worth more.

The term "worth" is important. Money earning 10% is worth more to its owner than the same sum earning 5%. So we are probably dealing with the idea that credit is worth less in the post 9-11 environment while at the same time regretting that we can't earn higher rates that were available only a relatively few years before.

The result was a cocktail of risk-a mix of more risk to earn a greater return and a willingness to take the risk because of a perception that the current environment is less risky as witnessed (if not proved) by the overall level of prosperity.

Learning from the harvest

We have entered a period of reevaluation of some longstanding assumptions that have significantly shaped our behaviors and expectations as both lenders and individual consumers of credit. The results of this process may have profound impacts on our business models and our industry's future and relative prosperity.

In future columns we'll explore some of the other contributory causes to the financial malaise. It's essential that we understand where we have been, before we decide where we want to go.

- About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent

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