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A Retrospective on the Global Financial Crisis

Northfield Information Services Commentary

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In a recent New York Times article Warren Buffett thanked the US Government for what he characterized as reasonably effective handling of what come to be known as the “Global Financial Crisis.” I agree with Mr. Buffett that the broad criticism of the government’s actions is generally unwarranted. While the handling of the crisis may not have been ideal, we will never know how bad the situation of the world economy might have become in the absence of such action. As things stand major stock market index values in the countries most affected have risen 75% or more from the low points observed during the crisis, suggesting that at least equity investors are regaining confidence in the future. In addition, much of the US government funds meant to target the financial crisis (i.e. TARP) have been repaid, and it is plausible that the government will actually break even on the entire direct expenditure. Still, it appears that the GFC has accelerated financial problems in various countries such as Greece, Portugal and Ireland. Unemployment remains stubbornly high in the USA and United Kingdom despite stimulus programs that have created record fiscal deficits in both countries.

Recent Northfield research on corporate sustainability is forthcoming in the Journal of Investing. A preliminary view of this work was published in our June 2010 newsletter

(<http://www.northinfo.com/documents/348.pdf>). One empirical finding that stands out in our minds is that the concept some financial institutions were “too big to fail” is not a recent phenomenon. At each month end from December 31, 1991 through March 31, 2010 we forecast the expected distribution of times to default dates for every company in our US models (including ADRs).

When You Need A Plumber, Don’t Call a Brain Surgeon!

February 25, 2009

Over the past ten years or so, the world economy and particularly the United States has experienced a widespread series of catastrophic failures in financial risk management. These failures have been pervasive at the level individual households, financial institutions and national governments.

1. You can’t borrow your way out of debt.

The restructuring of the US banking system should be entrusted to the market, not to closed door

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negotiations between representatives of the banks and the various regulatory agencies. My solution would be to have banks that need capital do a “shelf registration” that allows them to issue new shares of common stock as needed. Each Saturday, banks needing infusions of equity would issue new common shares that would be bought by the Federal government (TARP money) or by the Federal Reserve, at the Friday night closing trading price. This creation of new shares at market value is exactly the system that has worked reliably in mutual funds since the 1940s. As the transactions occur at market price, there is no element of a “bailout”. The government is paying for shares exactly what other investors are paying. There is no element of nationalization or economic dilution of existing shareholders, as the government is contributing capital at exactly what the consensus of investors say the shares are worth at a given moment in time. There is also nothing new about government entities investing in private firms. Every state and major municipality in the country has a pension fund for its retiring employees that is already substantially invested in the stock market.

To prevent the US government from having a controlling interest in any particular bank, I would create a mutual fund that could buy the bank shares from the government at market value as capital inflows from investors allow. Investing in this special fund would be permissible only by banks and other financial institutions that are in a healthy financial condition. As a way to incent healthy institutions to participate profits from this fund would be exempt from taxes, or paired with other economic incentives. Banks are certainly allowed to today to acquire other banks, or own large equity stakes in other banks. This structure allows the smaller institutions who have avoided the mistakes of

their larger brethren to be rewarded with new investment and business opportunities, while ensuring that the voting rights of the newly created shares are in the hands of people who actually know something about operating a bank in a prudent fashion.

2. We can't run the financial system as a house of cards.

Despite earlier shocks to the system, such as the shot gun marriage of Bear Stearns into JPMorgan Chase, the financial system froze up completely upon the failure of Lehman Brothers. Over the past twenty years, a greater and greater portion of financial trades were handled through “over the counter” transactions directly between financial institutions, as opposed to being processed through the exchanges that have been long established for the trading of stocks, options and commodities.

What has been broken is the system of prudent checks and balances that ought be in place to avoid the excessive buildup of financial risk in our individual conduct and the conduct of our institutions and government. •

Mr. diBartolomeo is President and founder of Northfield Information Services, Inc. Based in Boston since 1986, Northfield develops quantitative models of financial markets. Additional Northfield staff members are located in London, Tokyo and Chicago.

The firm's clients include nearly three hundred financial institutions in twenty countries.