

Financially Speaking

With Trisha Arndt, CFP®

How did this happen?

It's amazing how life comes full circle.

The very first edition of "Financially Speaking" that I wrote for the Verona Press in early 2006 focused on the reasons why conventional, fixed rate mortgages made sense for the majority of people buying homes. It talked about taking advantage of historically low mortgage rates and some of the potential pitfalls of plans that allow borrowers to pay less than the interest accrued each month.

Looking back it seems rather prophetic.

Now my column was aimed strictly at you the reader and looked at mortgages only from the viewpoint of the borrower. I didn't delve into the side of the lender or the potential pitfalls to the financial system as a whole. I don't claim to have had a crystal ball then and I certainly don't have one today. What I can do is try to explain what is happening in the financial system in a way that I hope makes sense.

Since the beginnings of the modern financial era in which money takes the place of tangible assets (i.e. the barter system) man has been prone to speculative excess and, eventually, to the reversal of that excess. In recent memory we have dealt with the collapse of the Nifty Fifty in the early 1970's, the first and second oil shocks in the late 1970s, the savings and loan crisis in the late 1980's and the tech bubble that ended in March of 2000.

To be certain the financial crisis we are facing today is monumental in scale, yet it shares many characteristics with past situations. So how did we get here?

On a very simplistic level we are facing a crisis because of the rise and fall of the real estate bubble.

A huge number of mortgages on the books are now collateralized by properties worth substantially less than the loan amount (if the property can be sold at all) and more and more are going into default. As this happens the holders of these mortgages face issues with decreased cash flow (because they are not receiving the mortgage payments) and a dramatic drop in assets as the mortgage securities must be valued using current property values. These problems are amplified by the fact that many of the firms involved have used leverage (i.e. borrowed money) to invest in these products. This results in a need for more and more borrowed money to fund day to day operations which has led to several institutions failing, merging or being propped up by government intervention.

Ultimately we hit a point where even traditional banks didn't want to lend to each other because everyone is hoarding cash. This has led to a credit crisis that affects us all as the

system virtually locked up, not allowing for normal loans to support business operations and growth or for consumers to allow for purchases of things like vehicles or homes.

The roots of this problem can be traced back much longer than many realize. Some economists even point to government initiatives put forth two decades ago, but I think most would agree that the real trouble happened during this decade. In my mind there were three major players in this fiasco and each had a major hand to play in the eventual mess.

The most popular villain in all of this is “Wall Street” in the form of mortgage originators and investment banks. Mortgage originators lent money seemingly without any discretion and created products that were difficult to understand and truly financially reckless for most borrowers. The investment banks then bundled these mortgages into securities and sold them like they were high quality bonds, seemingly without any risk analysis. To say they were greedy is an understatement.

To be certain the government has a hand in all of this too and must shoulder a portion of the blame. I know many like to point fingers along party lines (and those fingers point both ways) but if we are truly honest I think people on both sides of the aisle had a hand in this. Couple deregulation of the financial sector with big initiatives to “make it easier for everyone to own a home” and you have a recipe for disaster.

But despite all of the greedy Wall Street types and the politicians up on the hill, the consumer must take some of the blame. Too many people for too long played willfully ignorant and bought homes they couldn’t really afford, often with no money down and all too often using mortgage products that made no financial sense for a long term owner. Some treated the real estate markets like the stock market, buying and selling a number of houses at a time. Others used the equity in their house like a big ATM machine, knowingly living well beyond their incomes. Every one of them assumed it was ok because the property value would keep going up, a very common fallacy that has ultimately been proven the very hard way.

Someday our children will study this crisis in textbooks and learn about what led to it and how we responded. Let’s hope that these are lessons that won’t have to be learned again.

Trisha Arndt, CFP®, is president of Wealth Strategies of Wisconsin Ltd, 535 Half Mile Road, Ste 5B, Verona, 848-2400. Securities and Investment Advisory Services offered through Commonwealth Financial Network, member FINRA/SIPC, a registered investment adviser. Wealth Strategies of Wisconsin Ltd and Commonwealth Financial Network are separate and unrelated entities.