

## **The mistakes of Wall Street a history lesson for risk-lovers**

**By Denise Law**

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Commerce students considering a career on Wall Street face a grim lesson in greed as the U.S. credit crisis threatens to bleed into the Canadian economy.

When three of Wall Street's most lucrative institutions turned sour last month, it was clear that the seven-year shopping spree had come to an end. A nation living on credit could no longer pay its debt – and it all started with a simple idea – indulge now and pay later.

But for the U.S. consumer, this idea came with a hefty price: an economy on the brink of a recession. Financial experts now realize that the credit crisis isn't just about greed. It's about the people who simply didn't understand the risks they were taking.

“There was this massive loss of confidence following the 9/11 terrorist attacks,” said David Phipps, a senior financial advisor at Assante Wealth Management. “In order to stimulate the economy, the U.S. Federal Reserve lowered interest rates. When interest rates are low, people borrow money to invest and buy homes.”

The brokers who sold these mortgages didn't actually lend the money – the banks did. But for every mortgage sold, they pocketed the commission. By 2003, the housing market was so rife with consumer and investor confidence, prices shot up.

“So what ultimately happened was primarily due to greed,” Phipps said. “Loans started to be made to people who would not normally qualify for a mortgage – that's why it's called a subprime mortgage.”

So even so-called NINJAS – those with no income, no job and no assets – applied for loans. They didn't even need a down payment.

Then it got tricky. Investment banks entered the picture, creating an even bigger source of subprime lending. Instead of keeping the loans, they made commission by packaging them into complicated investments and selling them off to investors around the world. In other words, they passed the risk onto someone else.

At the time, mortgages *seemed* like a safe investment for everyone – the homeowner, the banks and the investors. The real estate market rarely failed – and even if it did – investors were insured by institutions like Freddie Mac and Fannie Mae. Everyone expected to get their money back, plus interest.

And for a while, it worked. As long as the price of homes went up, everyone benefited.

“But the pricing for homes was rising so rapidly that it started to squeeze people out of the markets,” said Beata Caranci, director of economic forecasting at TD Economics. “The subprime mortgages would reset – it was originally locked into a low interest rate – but after two years, it would reset to a market rate.”

The market rate, as it turned out, was much higher than what homeowners originally paid.

Forced to finance their houses at a rate they couldn't afford, many homeowners simply walked away from their properties. With the price of homes falling, it was clear that no one was getting their money back.

The housing bubble had burst, driving the U.S. economy into what analysts say will be the worst financial crisis since the Great Depression.

“We not only had reduced regulation, but did not enforce the rules on the books,” said Howard Chernick, a professor at the City University of New York. “There will always be cycles and bubbles. But good regulation can help to reduce the amplitude of the cycle.”

Over the past year alone, Wall Street has suffered its fair share of buyouts, bailouts and

bankruptcies. And when some of Wall Street's most prominent financial institutions faltered, the U.S. Federal Reserve stepped in to stop the bleeding – with the exception of investment bank Lehman Brothers Inc. – which took the fall last month when it filed for bankruptcy.

“One positive way of looking at this is that the U.S. Federal Reserve didn't want to create the impression that everyone gets bailed,” said Gordon Roberts, a professor of financial services at the Schulich School of Business. “The bailout would encourage institutions to take more risks. Somebody has to fail. In this case, it was Lehman Brothers.”

But some economists remain skeptical of market regulation, since it's difficult to put a cap on human nature.

“The crisis would have been hard to prevent. It would have required foresight on regulation,” Caranci said. “We want to make sure capital markets are as open and as freely functioning as possible. When you impose regulation, you have to do so with something in mind. Unfortunately, you don't find out until after the fact.”

By 2007, the financial crisis quickly found its way back into the U.S. economy. Unlike the tech bubble, which only affected the investors involved, the subprime mortgage crisis tightened up the entire credit system.

“When the banking industry stops lending money, especially to businesses, this creates a recession,” Phipps said. “That being said, if the United States goes into a recession, it's not good for the Canadian economy.”

Although the Canadian banking industry remained relatively unaffected by the credit crisis, the same can't be said for the rest of the world. Today, the Canadian economy is bracing for what analysts predict could be a long and tedious clean-up on Wall Street.

But for Prof. Roberts, who teaches MBA and EMBA students, there is a lesson to learn.

“There is no free lunch, by that we mean that if you get a higher return, it’s because you’re taking a higher risk. If there is a return with no risk, it’s probably too good to be true. Whether people actually learn this lesson is subject to some debate due to the nature of the business.”