The Financial Turmoil of 2007-0X: Causes, Culprits, and Consequences

George G. Kaufman
(Loyola University Chicago)

Symposium on Financial Crisis Management and Bank Resolution

University of Warwick
Coventry, U.K.
April 16-17, 2009

Importance of Turmoil / Crisis

- Failure and near-failure of large banks worldwide
- Need for government financial / capital assistance to many large banks to remain operating (partially or totally nationalized)
- Need for direct government /central bank liquidity assistance to nonbank financial and nonfinancial firms
- Reduction / slow growth in both bank and nonbank financing / lending to firms and households (credit crunch)
- Spillover to real economy causing low / negative growth, rising unemployment, and loss of faith in financial institutions and markets. Sharp decline in stock prices and personal wealth. Ignited recession and/or magnified "normal" recession.

Importance of Turmoil / Crisis (cont.)

- In U.S., sharp increases in mortgage defaults and foreclosures.
- Potential change in national economic structures from emphasis on market regulation to government regulation / ownership.
- Most significant peace-time economic / financial crisis in most industrial countries since 1930s.
- Further weaken the ability of the financial sector to absorb “normal” recession effects.

Important Questions

- How did problems in relatively small subprime mortgage sector in U.S. spread so quickly to banks throughout world and other sectors?
- What happened to promised benefits of risk sharing, diversification, and optimal risk allocation from securitization?
- Why did it take so long for both bank regulators and private sector to wake up to magnitude of problems?
- Why were so many proposed public policy prescriptions so poorly received and/or ineffective?
- What is future of market system / discipline and of regulatory structure?

Presentation Focus

- Will focus on U.S. and U.S. culprits / villains. Important because problem started in U.S. before spreading near world-wide. Many culprits the same.
- U.S. crisis triggered by end of housing price bubble in 2006. (No real estate bubble, probably no major crisis.) First public indication-- failure of 2 medium-sized German banks and relatively small U.S. and French hedge funds in summer 2007 due to investments in securitized subprime U.S. mortgages.(Also run on Northern Rock in UK due to bad mortgage loans and excessive short-term funding.)

U.S. Culprits

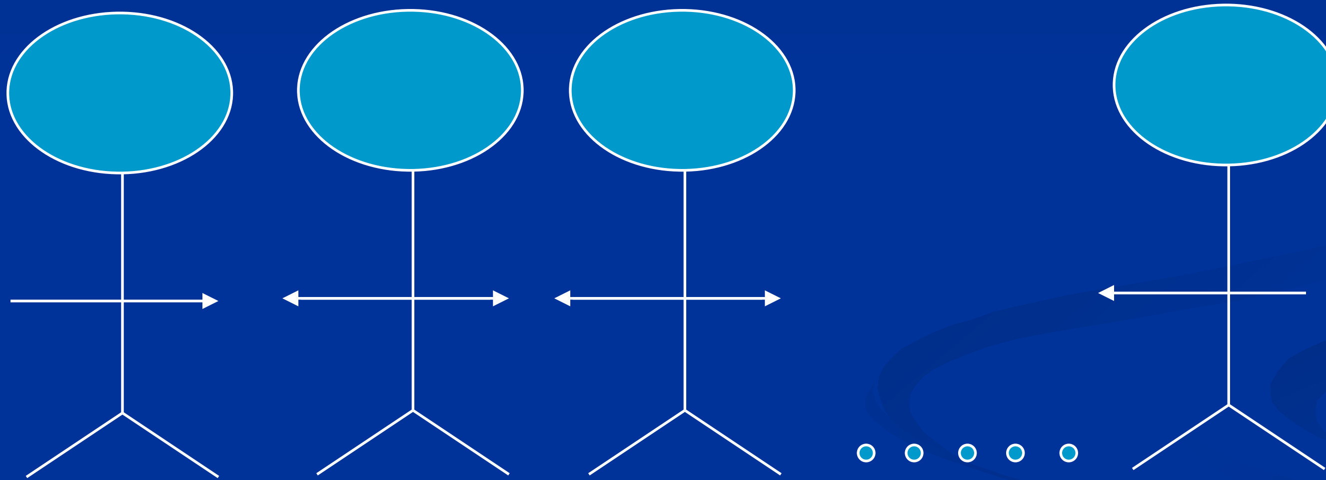
- Downturns / crises expose sins that exist but are mostly covered up / hidden during good times / booms
- Sins accumulate during booms until last one is one too many and breaks the camel's back. In 2007, it was the end of the housing price bubble.
- Long list of culprits for 2007-0X crisis housed in all sectors – private and public / government. Both market and regulator (not necessarily regulation) failures. "We have met the enemy and they are us!"
- Perfect storm

Important Culprits / Villains in U.S. include:

- Central bankers – monetary policy
- Commercial bankers – initial and ultimate lenders.
- Credit rating agencies
- Financial engineers
- Government (Congress and the Administration)
- Investors / Ultimate lenders
- Mortgage borrowers
- Mortgage brokers / salesmen
- Prudential bank regulators

Some of their sins include:

Culprits Fingering Others



Central Bankers (Fed) / Monetary Policy

- Low interest rates too long in early 2000s fueled housing price bubble and excessive corporate leverage, including by hedge funds and private equity.
- Insufficient concern about housing price bubble and potential bursting.
- Insufficient weight to impact on aggregate consumption of equity extraction from mortgages
- Misdiagnosis – failure to distinguish between liquidity and solvency problem at banks.

Commercial Bankers

- Excessive leverage/insufficient capital for risks assumed
- Based basis for mortgage loans increasingly on expected increases in home prices rather than borrower income.
- Poor credit analysis of both mortgage loans and mortgage structured securities –outsourced too much
- Poor stress testing of loan portfolios, including security correlations within portfolios at time of stress.
- Poor internal control systems

Commercial Bankers (cont)

- Poor compensation plans focusing on/incentizing loan production rather than loan performance and overly short evaluation period.
- Failed to keep high risk parts of securitized MBS/CDOs on own books.
- Some off - BS conduits (SIVs) not really put off – BS – -- maintained reputation (sponsor) risk
- Senior officers did not fully understand complex securities or risk models used (black box risk).

Credit Rating Agencies

- Poor / incomplete credit analysis of complex mortgage securitized products, particularly losses on defaults (LGD).
- Insufficient model testing of large national declines in housing prices on LGD.
- Poor transmittal of information of interpretation of letter grades across security types
- Charge issuer for rating (conflict of interest).

Financial Engineers (“Mad Scientists”)

- Designed highly complex and difficult to understand models for measuring risk exposure
- Failed to test models sufficiently robustly with outlying / crisis observations
- Designed highly complex, opaque, and highly levered securitized products (not securitization per se)
- Failed to recognize information (primarily soft information) loss in transmission across multi-layered security tranches

Government (Congress and Administration)

- Encouraged / required mortgage lending to low income / minority / high risk households at “low” interest rates
- Permitted insufficient capital for government sponsored mortgage lenders
- Encouraged low downpayment (high leverage) on mortgage loans
- Actively promoted home ownership for own sake

Investors/Ultimate Lenders

- Failed to do proper credit evaluation, testing, and due diligence. Outsourced much to third parties (credit rating agencies)
- Failed to charge appropriate risk premiums. Caught up in euphoria
- Failed to understand risk complexity of new type structured securities purchased (innovation risk)
- Pressured credit rating agencies for higher ratings if such ratings required by investment regulations

Mortgage Borrowers

- Borrowed on basis of expected increase in home prices rather than on income.
- Failed to understand complexities of mortgage instruments
- Leveraged too highly
- Failed to provide accurate and informative documentation
- Failed to see “if mortgage too good to be true” likely isn’t true
- Refinanced to larger loans (cashed out equity) at lower interest rate but larger monthly payments

Mortgage Brokers / Salesmen

- Extended mortgage loans on excessive reliance on expected increase in house value / price rather than on borrower income and ability to repay
- Extended mortgage loans aggressively on insufficient and undocumented / unverified information (carelessness or fraud)
- Extended mortgage loans on broker driven overstatement of borrower income and ability to make payments (fraud)
- Poor compensation package focusing on loan production over loan performance

Prudential Bank Regulators (U.S.)

- Required insufficient capital (excessive leverage) for banks, particularly in bubble environment. Opposed capital leverage ratio requirement. Over emphasis on Basel I & II.
- Failed to be sufficiently concerned with financial stability. Neither published financial stability report nor participated in IMF financial sector surveillance program
- Failed to prevent too low downpayments (excessive leverage) on mortgage loans.
- Misdiagnosis --failed to distinguish solvency from liquidity problem for banks and considerable reluctance to publicly admit to solvency problems.
- Opposed mandatory subordinate debt requirement for large banks

Prudential Bank Regulators (U.S.) cont.

- Failed to identify magnitude and ownership of complex structured mortgage securities
- Failed to pursue off-balance sheet SIVs.
- Exempted GSE debt and preferred stock from bank diversification and risk requirements.
- Abetted circumvention of bank size restrictions in acquisitions
- Failed to aggressively enforce PCA and permitted and participated in known violations

Prudential Bank Regulators (U.S.) cont.

- Unprepared to resolve insolvent large "systemic" institutions and deal with potential contagious spillovers, including different resolution regimes for banks, bank holding companies, and other financial institutions.
- Regulator vs. regulatory failure (lax regulations or lax regulators?) – principal agent problem/poor incentive structure.

Why Review Past Problems and Make Case for Reform?

- Optimist – Avoid repeating errors

  George Santayana (1863-1952)

  "Those who cannot remember the past are condemned to repeat it"
- Pessimist – Most do remember the past

  George Kaufman (alive)

  "Those who can remember the past are condemned to agonize first and then repeat it"

- Careful not to either "throw out baby with bath water" or "destroy economy in order to save it."

Leveraging Down Is Hard To Do

Based on the lyrics and music of *Breaking Up Is Hard To Do*
Written by Neil Sedaka and H. Greenfield
#1 on Billboard chart in August 1962

Don’t take my home away from me
Don’t you leave my life in misery
If it goes then I’ll be blue
‘Cause leveraging down is hard to do

Remember when I had my house
And I slept soundly without a grouse
Think of all that I have lived through
Leveraging down is hard to do

They say that leveraging down is hard to do
Now I know, I know that it’s true
Don’t say that this is the end
Instead of leveraging down I wish that we were leveraging up again

I beg of you, don’t take my home
It will leave me bare bone
Come on bank, let’s start my mortgage anew
‘Cause leveraging down is hard to do

Thank you.