The role of banks and lending institutions in ensuring responsible and sustainable management practices: The case of the 2008 financial crisis

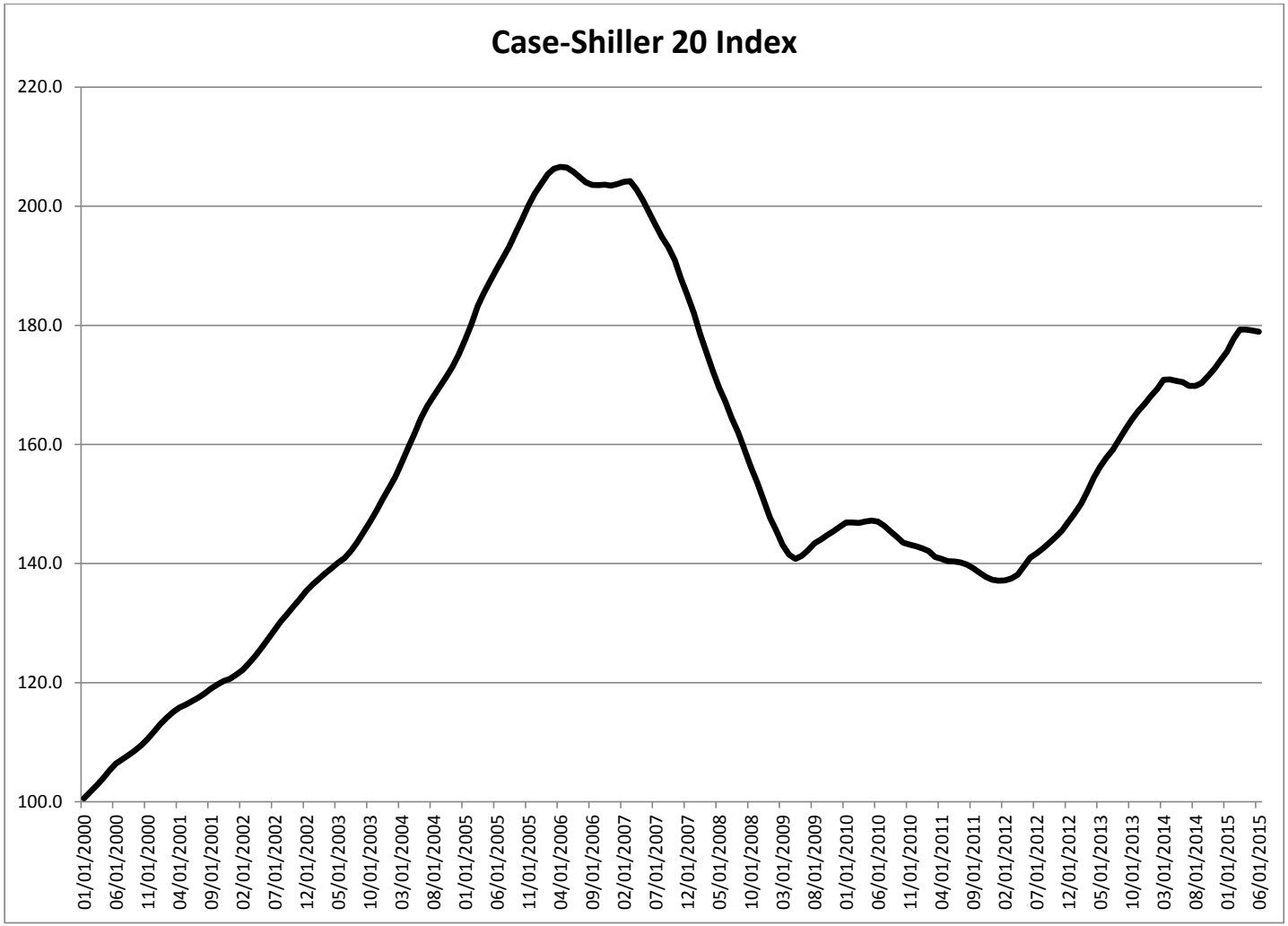
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Progression of Topics

1. Housing Market
   - Assumptions
   - Incentives
   - Structure
2. Financial Institutions
   - Investors and Creators of Securities
   - Mortgage Companies
   - Credit Default Swaps
   - Structured Investment Vehicles
   - Fraud
3. Government and Central Banks
   - Executive and Legislative Branches
   - US Treasury
   - Federal Reserve
4. Going Forward

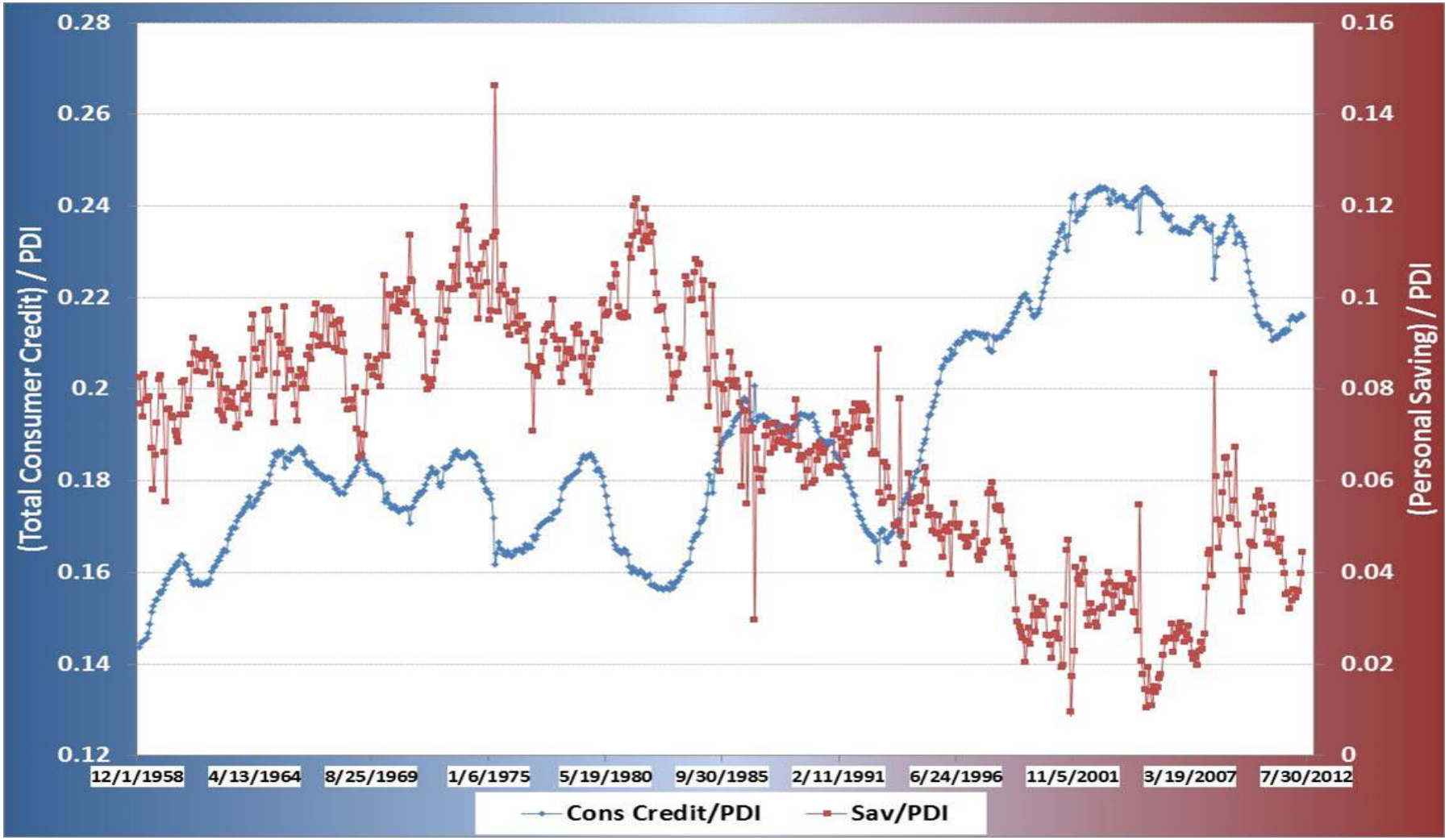
Housing Prices since 2000



Collapse of the Housing Market

- Interest rates were substantially low through mid 2005
- MBS became an increasingly popular asset
- Fueled housing bubble with larger share of subprime loans
- Subprime loans began to default when interest rates rose in 2005
- Housing prices were free-falling as the "bubble popped"

Trend in Savings/Consuming

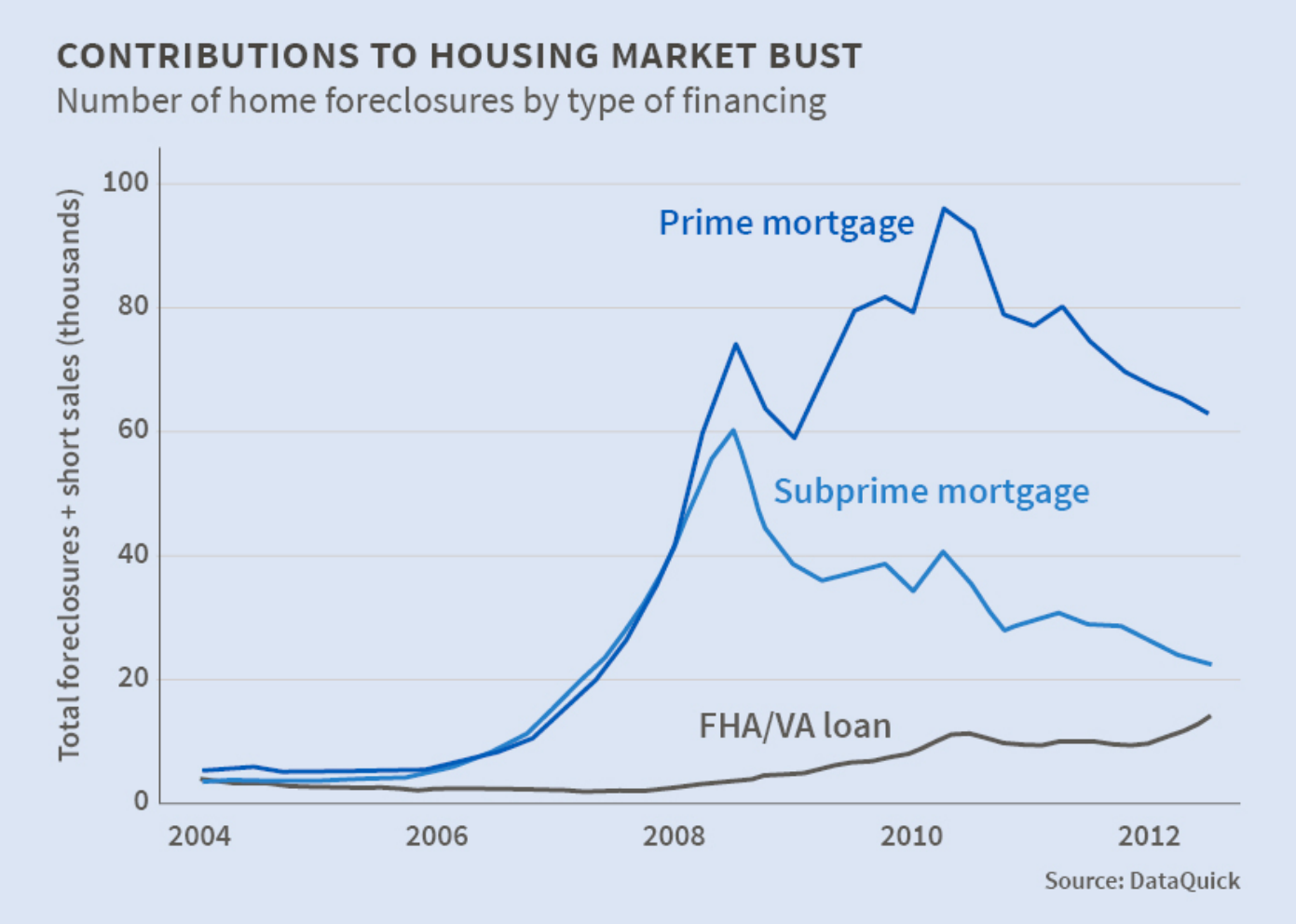


Pre 2007 Assumptions

- Housing prices were rising fairly consistently
  - Strengthened belief of future increases
  - Fueled further borrowing for consumption goods
  - Formed self-fulfilled speculative bubble
- Correlation of housing prices within cities and between cities poorly understood
  - More like fire or natural disaster - local and non-contagious

Foreclosures - Prime and Subprime

Spilled over to entire housing market - overly leveraged



Incentives

- Payment for Houses
  1. Realtor
  2. Mortgage Broker
  3. Bank
  4. Investment Bank
  5. Investor

- Incentives work so all get paid for sales; not safe sales or almost sales

Structure

- Newer derivatives created and used for mortgages
  - Collateralized Debt Obligations (CDO)
  - CDO^2
  - MBS
  - Credit Default Swaps (CDS)
- Bundling, re-bundling, and frequent selling
  - Difficult to rate
  - Difficult to parse out individual mortgages

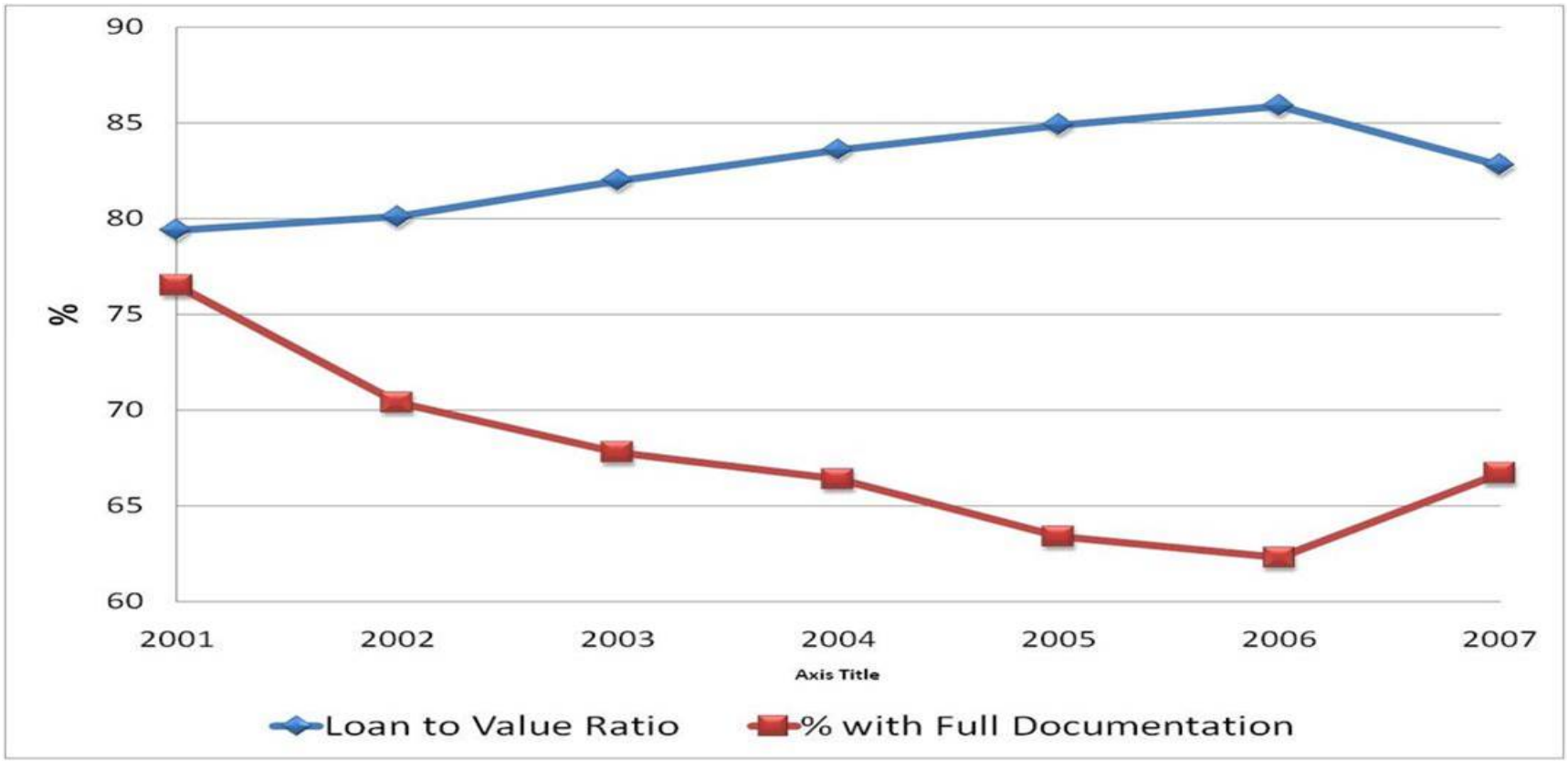
Investors and Creators of Securities

- Easy to over-invest in these assets
  - Rated AAA and pay higher than t-bonds
  - Speculation and over-confidence
  - Group behavior - everyone else is cashing in
- Hard to appropriately assess value, risk, and payments of MBS and CDO

Mortgage Companies

- Fannie Mae and Freddie Mac
- Shift in mortgages from government-sponsored enterprises (GSE) to private-label securitization (PLS)
  - Deteriorated underwriting standards
  - Transition from FRM to ARM to keep market share
- Too big to fail? - Not explicit but assumed by rest of market
  - Riskier but GSE made appear safer

Deteriorating Lending Standards



Credit Default Swaps

- CDS a valuable way to hedge risk
  Pay if CDO loses value
- Value of total CDS far exceeded the value of CDOs they backed
- No ownership of CDO needed
- Hedging became gambling and speculation
- Small segment of AIG caused large problems

Structured Investment Vehicles

- Separate "online" banks formed from supporting banks - shadow banking
- Performed activities off supporting bank's balance sheet
- Lived on short-term loans (CP) to buy long-term assets (MBS)
  - More transparent than investment banks and less leverage; regulated like regular bank
  - When crisis hit, lenders called in CP for liquidity
  - SIVs could not sell enough assets to cover
  - Insolvency akin to a bank run
  - Supporting banks forced to absorb losses

Blatant Fraud and Deceit

- Making MBS doomed to fail - CDS payout
- Nogotiaging assets of securities with rating agencies
- Off-loading risky assets to hide exposure from regulators
- Lack of underwriting standards (i.e. down payment from separate loan)

Executive and Legislative Branches

- Complete lack of foresight during boom
- President Clinton and Congress
- Brooksley Born and CFTC
  - Disregard to warnings before 2001 stock collapse
  - Overwhelming support to **NOT** regulate OTC derivatives
  - Born essentially defanged and dethroned - 1999

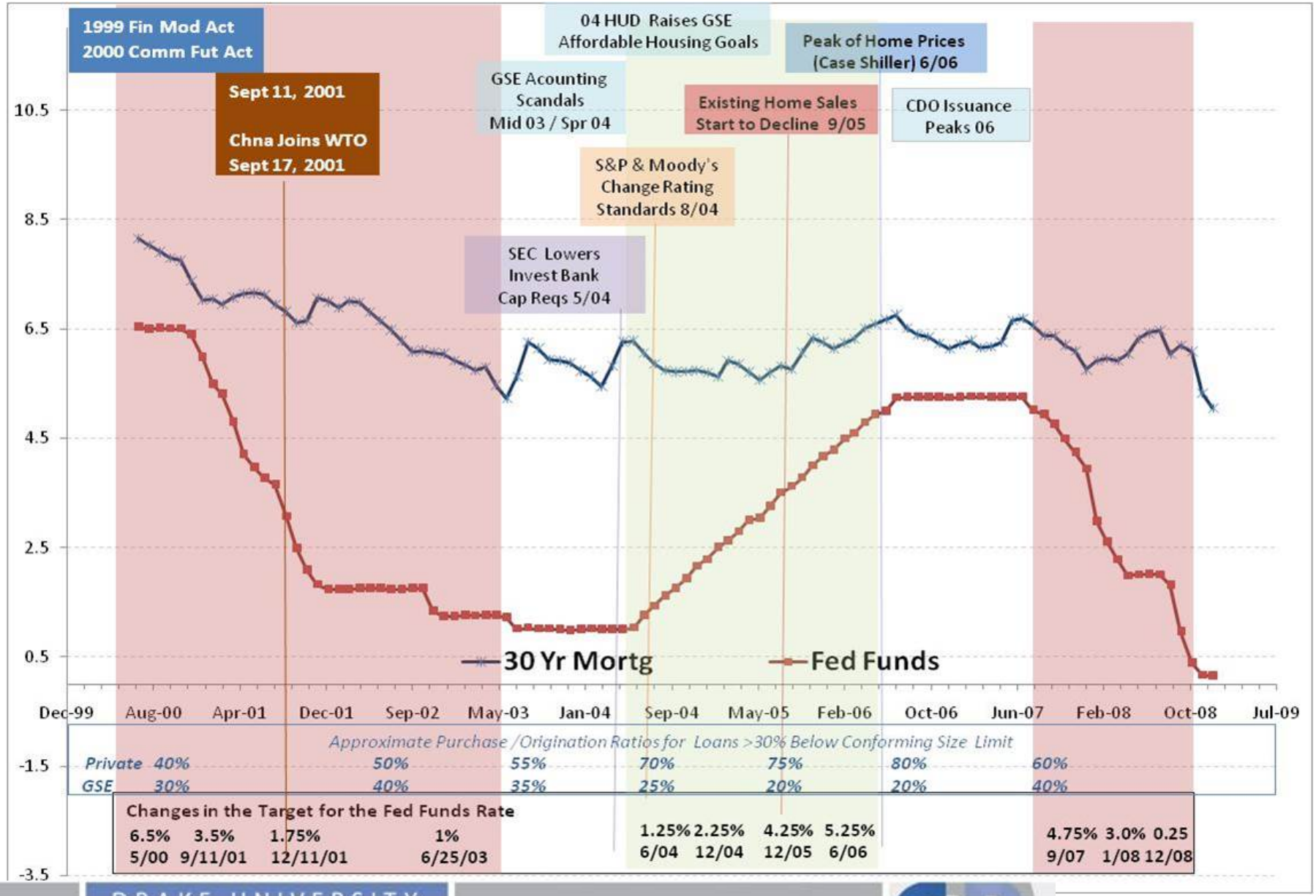
US Treasury

- Highly uncertain outcomes
  - Bear Sterns
  - Lehman Brothers
  - AIG
  - Freddie and Fannie
- Aided in trading stoppage and liquidity shortage
- Bailout of "Wall Street" and not "Main Street" - TARP

Federal Reserve

- Alan Greenspan and Ayn Rand
  - Belief that markets do not allow bubbles to exist
  - Driven by ideology not pragmatism
- Ben Bernanke
  - Used every policy tool to max
  - Created and used new and inventive tools
  - Credited for saving the financial system
  - How to unwind policy?
  - Criticism of stress tests

Big Picture


1999 Fin Mod Act
2000 Comm Fut Act
Sept 11, 2001
Chna Joins WTO
Sept 17, 2001
04 HUD Raises GSE
Affordable Housing Goals
GSE Acounting
Scandals
Mid 03 / Spr 04
Peak of Home Prices
(Case Shiller) 6/06
Existing Home Sales
Start to Decline 9/05
CDO Issuance
Peaks 06
S&P & Moody's
Change Rating
Standards 8/04
SEC Lowers
Invest Bank
Cap Reqs 5/04
10.5
8.5
6.5
4.5
2.5
0.5
-1.5
-3.5
30 Yr Mortg
Fed Funds
Dec-99
Aug-00
Apr-01
Dec-01
Sep-02
May-03
Jan-04
Sep-04
May-05
Feb-06
Oct-06
Jun-07
Feb-08
Oct-08
Jul-09
Approximate Purchase /Origination Ratios for Loans >30% Below Conforming Size Limit
Private 40% 50% 55% 70% 75% 80% 60%
GSE 30% 40% 35% 25% 20% 20% 40%
Changes in the Target for the Fed Funds Rate
6.5% 5/00
3.5% 9/11/01
1.75% 12/11/01
1% 6/25/03
1.25% 6/04
2.25% 12/04
4.25% 12/05
5.25% 6/06
4.75% 9/07
3.0% 1/08
0.25 12/08

Into the Future

- Mix of improbable outcomes but severe losses
- Companies bending rules to maximize leverage and profits
  - Failure to recognize systemic risk
    -A drop of water never feels responsible for flood
- Willing to lose 0.5% on profit margin to keep less exposed?
  - Akin to precautionary savings

Conclusion

"The U.S. economy, once the envy of the world, is now viewed across the globe with suspicion. America has become shackled by an immovable mountain of debt that endangers its prosperity and threatens to bring the rest of the world economy crashing down with it. The ongoing sub-prime mortgage crisis, a result of irresponsible lending policies designed to generate commissions for unscrupulous brokers, presages far deeper problems in a U.S. economy that is beginning to resemble a giant smoke-and-mirrors Ponzi scheme. And this has not been lost on the rest of the world." - Hamid Varzi, International Tribune