

# Lessons from the Crisis

Franklin Allen  
University of Pennsylvania

European University Institute  
October 16, 2008

# What caused the crisis?

- The conventional wisdom is that the basic cause of the current crisis was bad incentives in
  - the origination of mortgages
  - the securitization of them
  - the provision of ratings for securitizations
  - risk management systems

# But the main cause...

- The Federal Reserve and other central banks held interest rates too low for too long and this caused a bubble in property prices
- Without the significant drop in property prices there would not have been a problem in the mortgage sector

# Why was there a proliferation in subprime mortgages?

- What was the reason subprime mortgages became so important?
- Why were they introduced and why have they caused such a problem?
- If we regulate them will we prevent the problem going forward?

# Tax arbitrage

- In the US interest is tax deductible but rent is not
- This creates a significant incentive to turn rent payments into tax deductible interest payments
- This is what 100% mortgages do

# The arbitrage works as long as...

- Property prices keep rising
- If they fall then the arbitrage no longer works
- But property prices in the US had not fallen on average since the Great Depression (relevance of Asia?)
- In years prior to the crisis real estate had outperformed other assets so it seemed like a good bet

# Lesson 1

**Central banks need to think carefully about the effects of monetary policy on asset prices, particularly property prices and about global imbalances**

In the past very few central banks have done this. For example, the Federal Reserve argued targeting asset prices was not possible and focused solely on consumer price indices of inflation.

# What happened in the summer of 2007 at the start of the crisis?

- The prices of AAA-rated tranches of subprime securitizations fell dramatically in a short period of time
- When markets are efficient this indicates that information about the underlying quality of the assets deteriorated
- This led to the conventional wisdom that bad incentives in the mortgage industry were to blame

But not just subprime mortgages were affected:



Co-movement between securitizations of AAA-rated tranches of subprime mortgages, commercial mortgages and firm CDSs increased<sub>9</sub>

- The prices of AAA tranches of securitizations went to levels that were very difficult to explain on the basis of fundamentals
- The April 2008 Bank of England Financial Stability Report deduced that prices of these securities at that time implied a 38% loss rate – consistent with a 76% default rate and an eventual 50% loss given default – that seemed much too high
- How can prices be so low if it is not fundamentals?

# Alternative to the Bad Incentives View: Mispricing

- New information about subprime defaults led to a realization they were more risky than previously thought
- This led to sales of the AAA tranches as portfolios were readjusted
- The volume of sales overwhelmed the absorption capacity of the secondary markets for securitized assets and prices fell below fundamentals

- Once the link between prices and fundamentals for these products was broken it became risky to try to arbitrage
- These “limits to arbitrage” (Shleifer and Vishny 1997) prevented prices returning to fundamentals
- It is like the dot.com bubble in that trying to arbitrage internet stocks led to bankruptcy
- The LTCM crisis arguably also exhibited mispricing

# Mispricing and the Paulson Plan

- The mispricing view of the crisis underlay the Treasury and Fed view that subprime mortgage assets could be bought at “hold-to-maturity” prices well above market prices and taxpayers could also make money
- This was not well explained when the plan was presented to the public and Congress

# Lesson 2

**Careful research is needed to distinguish the relative importance of the Bad Incentives View and the Mispricing View**

The two views have distinctly different implications for regulation and risk management going forward, e.g. mark-to-market accounting

# Why didn't regulation prevent the crisis?

- Banking regulation is different from other kinds of regulation in that there is no wide agreement on the market failures it is designed to correct
- It is backward looking in the sense that it was put in place to prevent the recurrence of past types of crises

# How should banking regulation be designed?

- What are the benefits and costs of regulation?
- What exactly are the market failures?
- The Basel agreements illustrate the lack of a widely agreed theoretical framework

# The market failures

The most important are:

1. Inefficient liquidity provision
2. Mispricing due to limits to arbitrage
3. Contagion

# Lesson 3

**Banking regulation needs to be designed to solve market failures rather than imposed piecemeal as a reaction to crises**

Many banks focus on satisfying current regulations rather than thinking ahead and arguably current regulation hurts rather than helps

# Cross-border cooperation

One of the most worrying aspects of the current crisis is the possibility for contagion across borders

UBS and the “too big to save” problem

The international community needs to do much more to coordinate crisis management

The crisis has provided many examples of lack of cooperation

# Lesson 4

**Put in place a system of burden sharing so that crisis management can be effective in case a large multinational bank is faced with bankruptcy**

Particularly important for the EU with its goal of a single market in financial services

A role for the IMF?

# What's going to happen next?

- What precedents provide the best guide?
- In the US we have not had situations like this on a nationwide basis since the Great Depression but in other parts of the world there have been many financial crises
- What is the most similar?

# Japan in the 1990's

- In the 1980's the Japanese economy boomed
- There were huge increases in stock prices and particularly property prices
- Was it a bubble?

# The Japanese Bubble

- The Nikkei index was around 10,000 in the mid-1980's and peaked at just under 40,000 at the end of 1989
- In recent days almost 20 years later it has been trading around 8,000-9,000
- What about property prices?

# The Lost Decade in Japan

- Property prices peaked in 1991 and then fell continuously for about 15 years ending up around 70-75% from their peak value
- This caused huge problems in the banking system that spilled over into the real economy
- Growth fell from being among the highest in the world to the lowest in the developed world

# Will it be as bad in the US?

- The housing price bubble was much smaller in the US
- The deviation from long term growth trend in property prices in the US was about 25%
- They have fallen about 10-20% so far suggesting about another 5-15% to go
- This would be painful but not catastrophic

# Except...

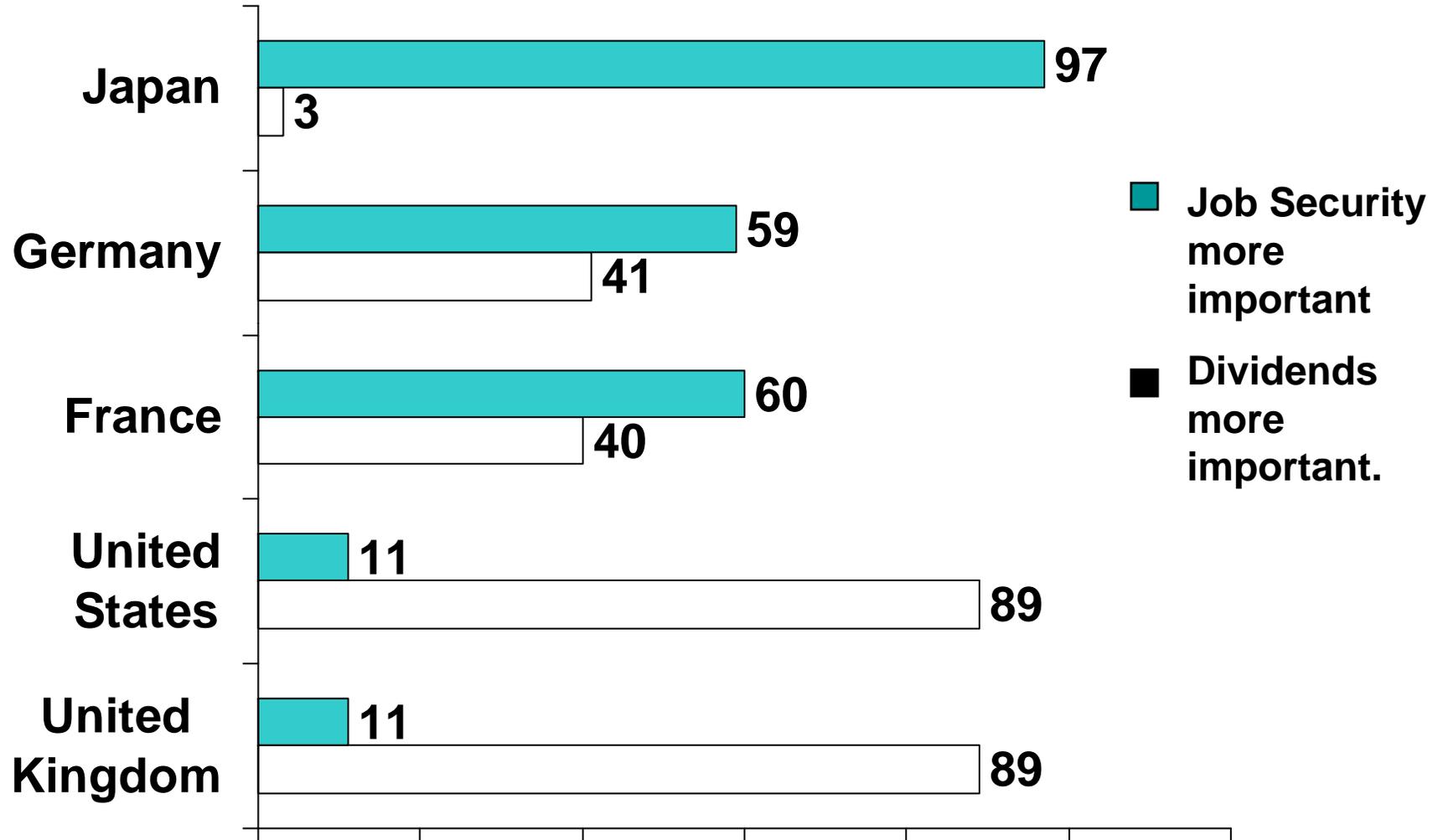
- Japan has a very different kind of economy in terms of the way that firms and banks reacted to the downturn
- In particular firms place great weight on the interests of employees and other stakeholders

# Firm priorities

Survey of managers:

- Which of the following two would be the most prevalent view in your country?
  - (a) Executives should maintain dividend payments, even if they must lay off a number of employees
  - (b) Executives should maintain stable employment, even if they must reduce dividends

# Job Security or Dividends?



# How stable is the US economy relative to Japan?

- Japan stopped growing fast in the 1990's but the economy did not have a long lasting deep recession
- How much of this was due to firms' reluctance to lay off workers and of banks to call in loans?
- What happens when the US falls into recession - how strong will the feedback effects be?

# Lesson 5

**It is important to understand the experience of Japan in the 1990's and the determinants of feedback effects such as corporate governance**

This is a key area for research going forward

# The UK plan and successors

Nationalizing the banking system is a bold step

- Removes bankruptcy risk and contagion risk

But

- Why bail out equity holders?
- Debt overhang – why bail out bondholders?
- Transfers risk to governments (Irish debt)
- Credit market and interbank market freeze: Fear of default versus liquidity hoarding