LESSONS FROM THE FINANCIAL CRISIS

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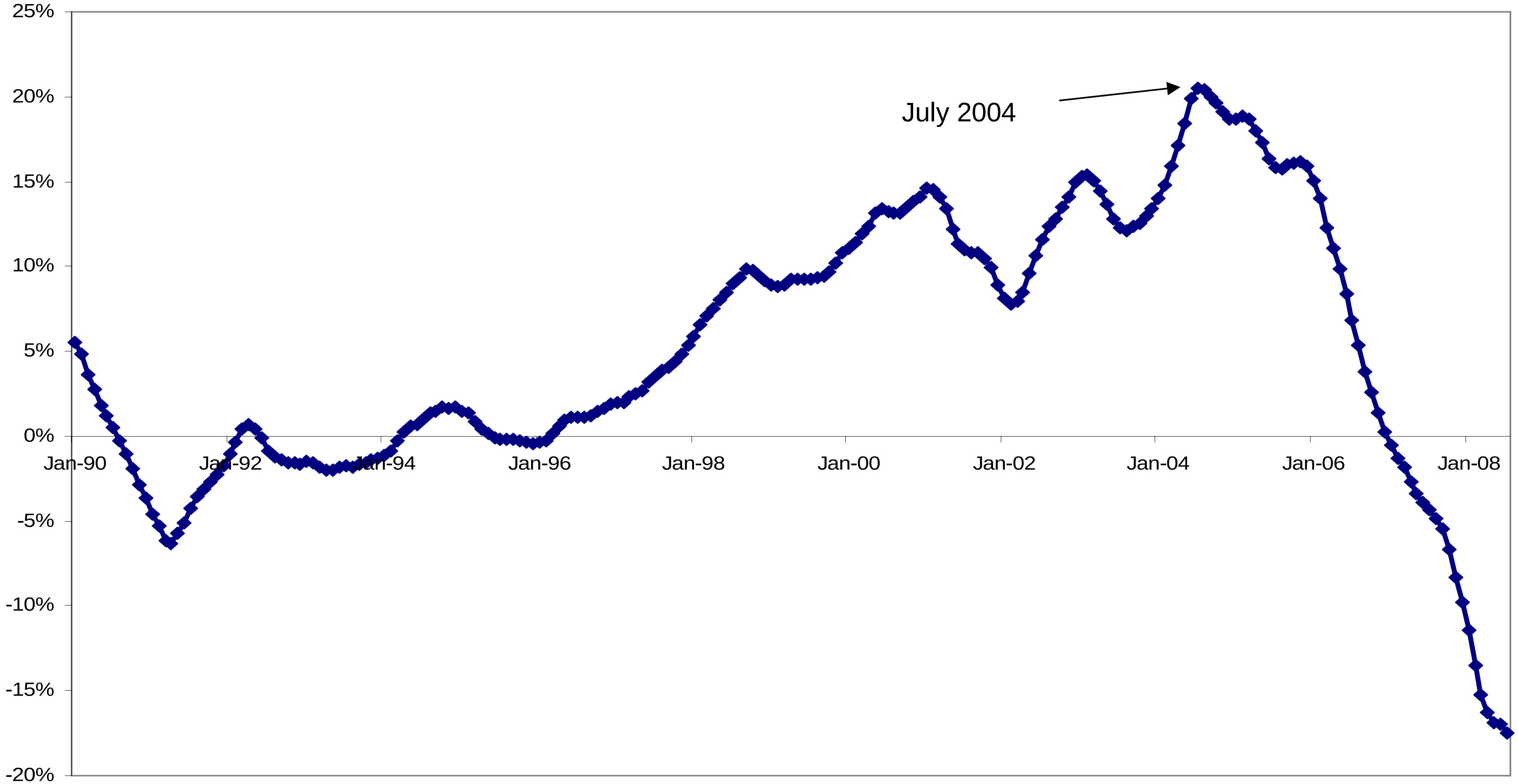
The House Price Bubble was the Biggest "Cause" of the Problem

When house prices decline, delinquency and default rates increase because people are under water. In this bubble, home prices have fallen roughly 20 percent from their peak, and some analysts' estimate* that prices will eventually drop 35-40 percent from peak to trough

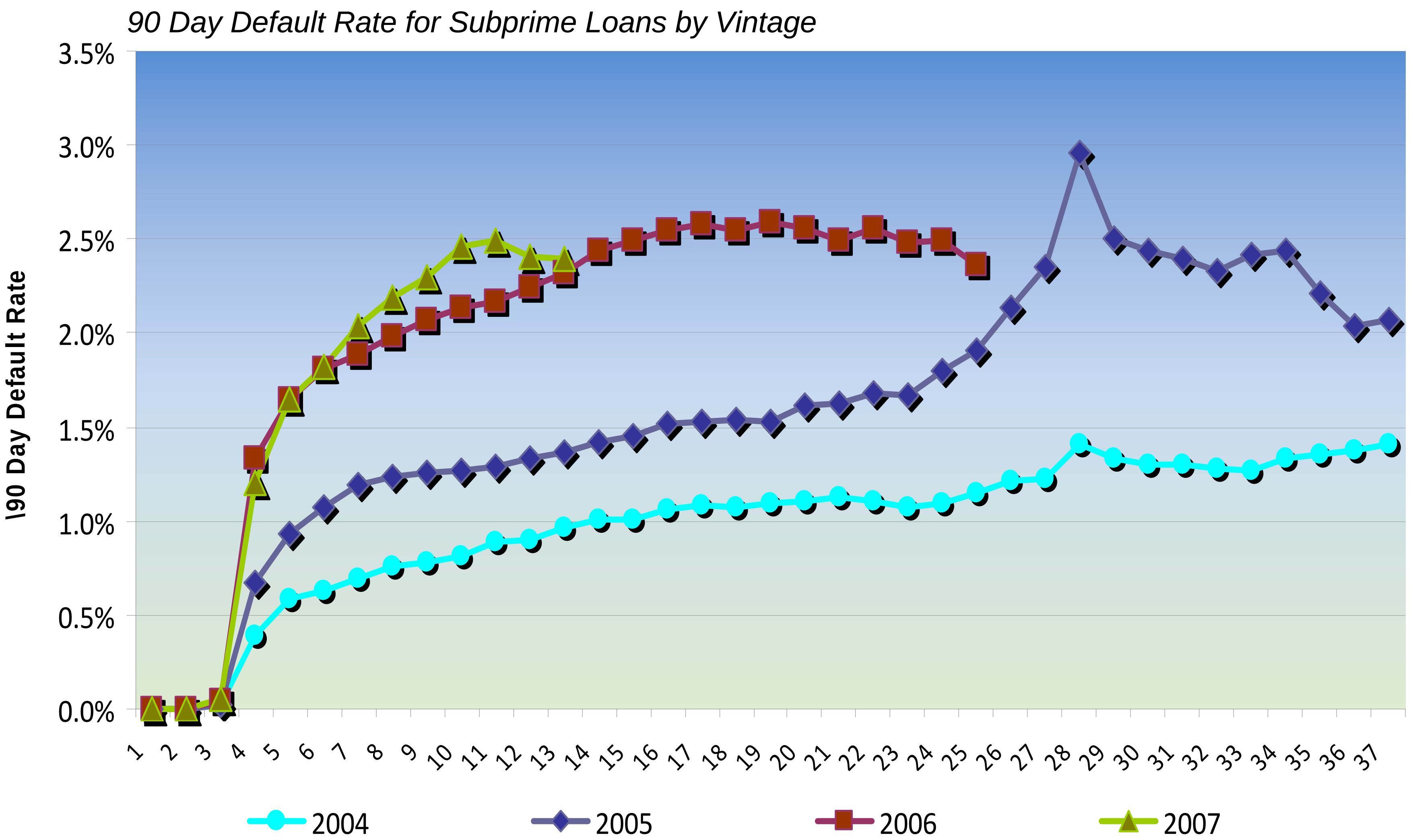
Case-Shiller 10-city Home Price Index; year-on-year monthly growth rate, in percent



Source: S&P / Case-Shiller Index

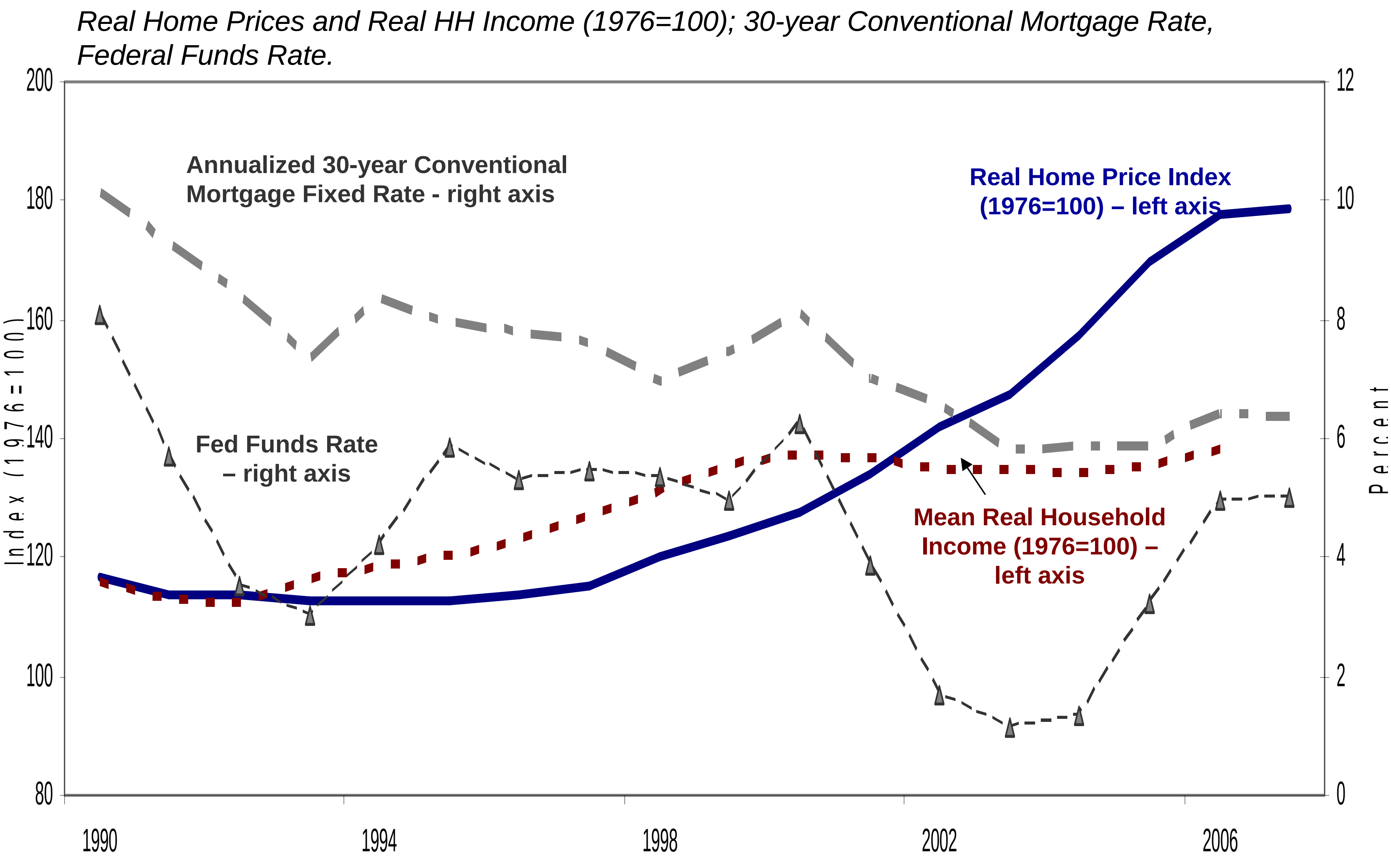
* Based on estimate from Meredith Whitney from Oppenheimer Bank

Delinquency by Vintage Shows the Effect of the Price Bubble, as well as the Erosion of Lending Standards. The Combination of the Two Factors was a Disaster—Lending Standards Eased when they Should Have Tightened.



Source: McDash Analytics

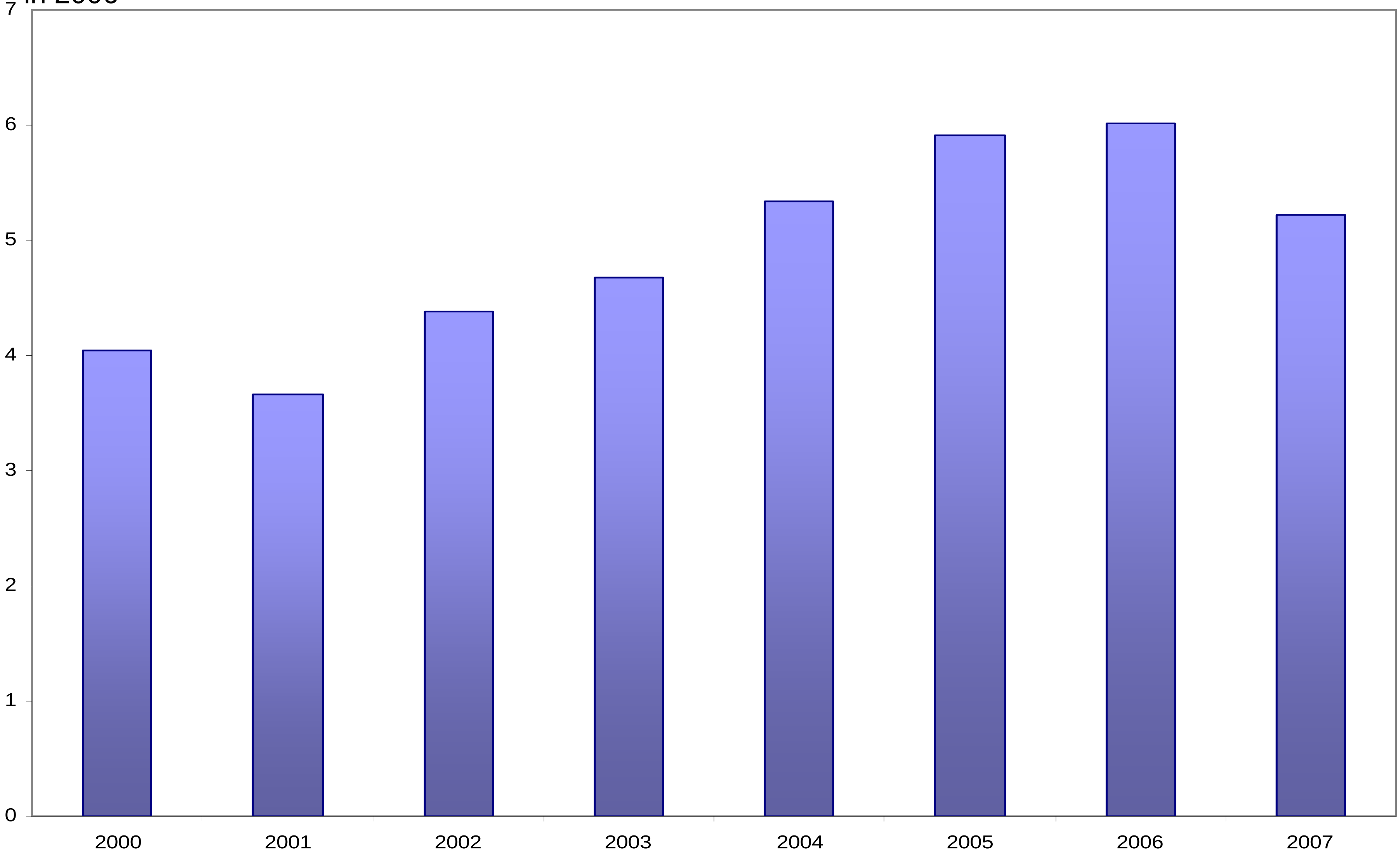
Low Interest Rates Fueled the Price Rise. Was FED interest rate policy to blame? Maybe. House Prices Flattened when the Funds Rate was Increased.



Source: OHFEO; Federal Reserve; Bureau of the Census

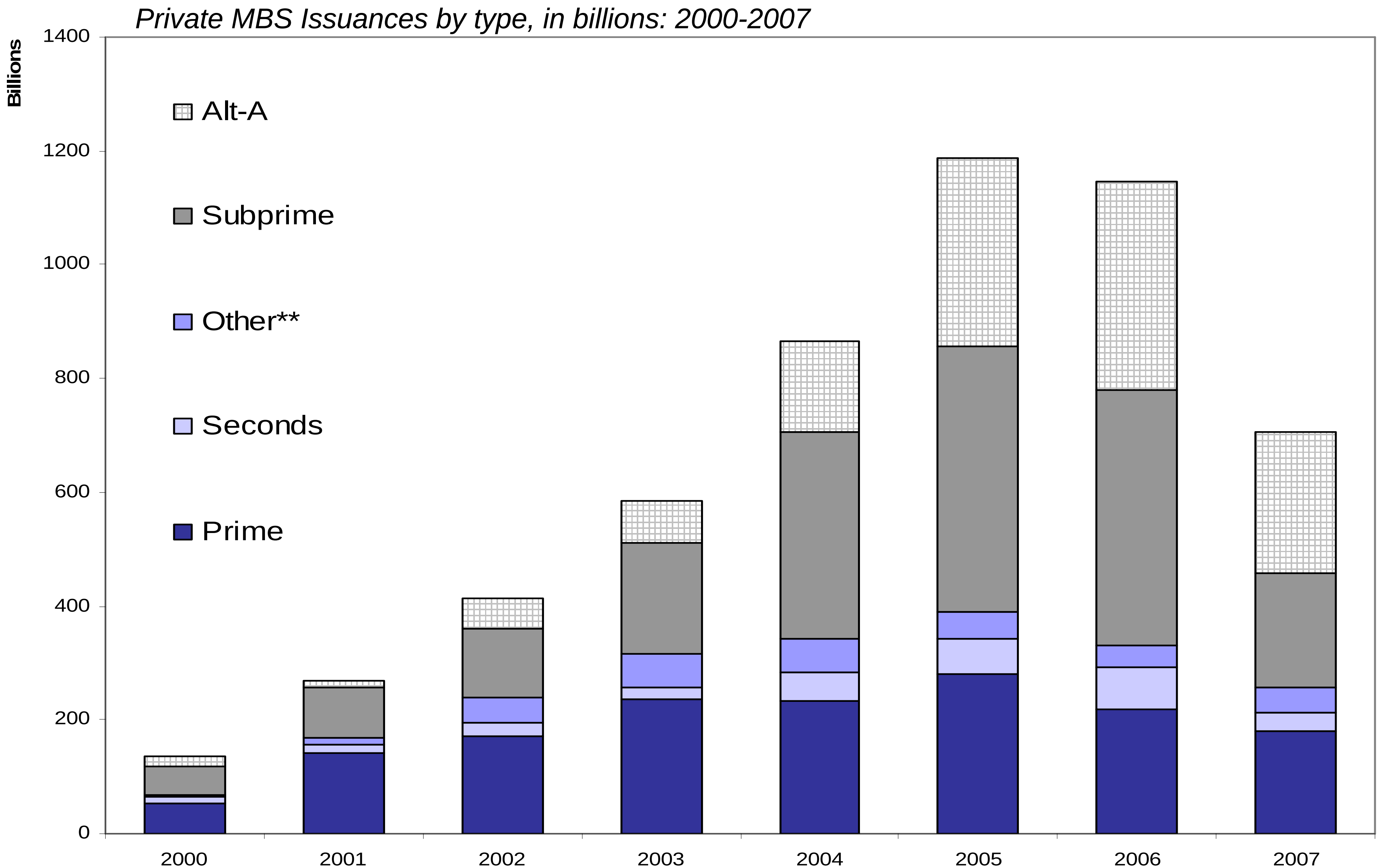
The Global Savings Glut and the Flow of Money to the US Market Kept Rates Low

Capital Inflows to the US Economy (Equal to the Current Account Deficit) Reached Over 6 percent of GDP in 2006



Source: Bureau of Economic Analysis

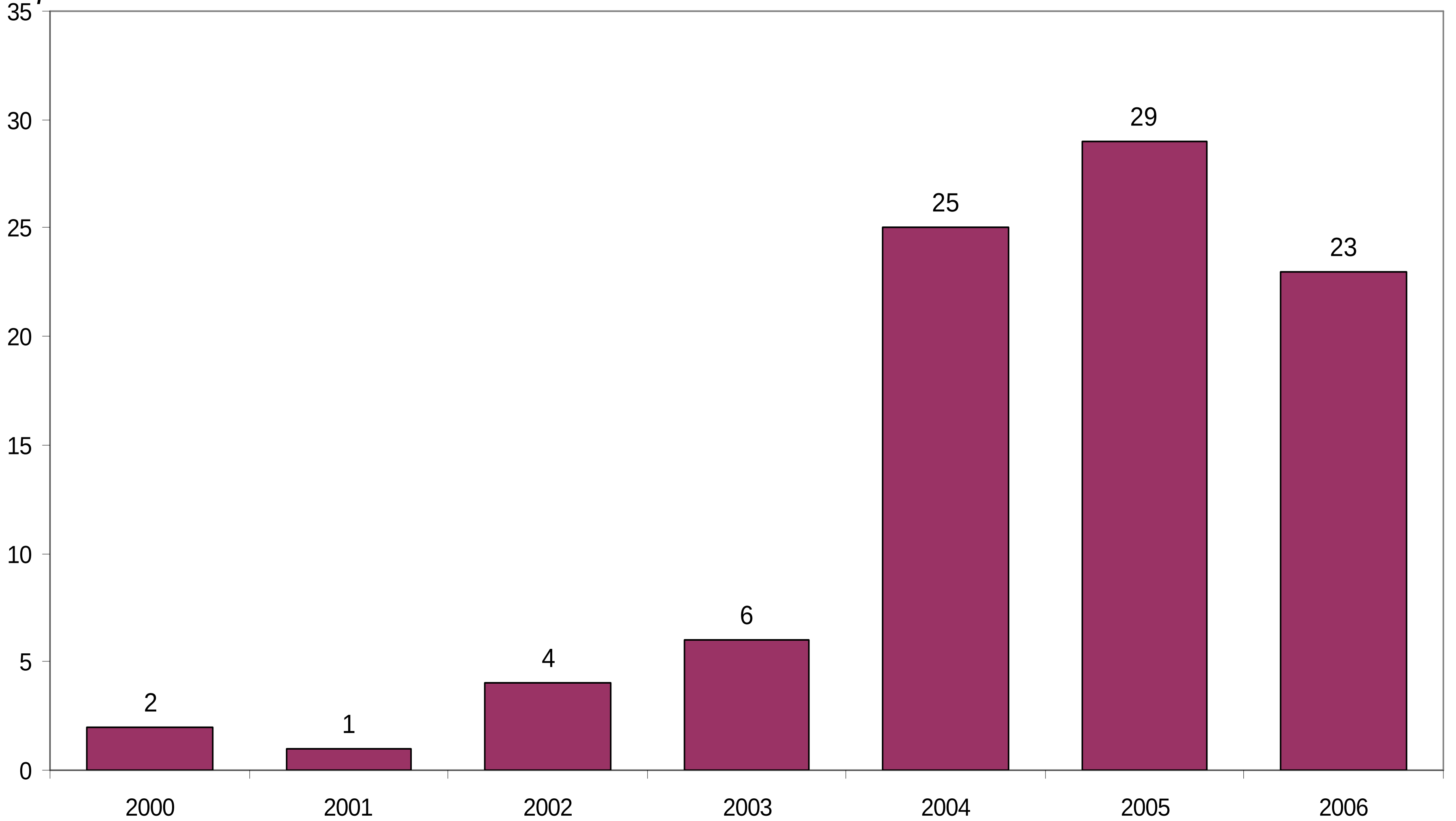
Increased Securitization Channeled Funds Into the Subprime Mortgage Market and Masked the Risks Faced by Investors. Credit Rating Agencies Failed to Warn Buyers of the Real Risks.



Source: Inside Mortgage Finance. Other includes Scratch & Dent, Re-MBS, and "other"

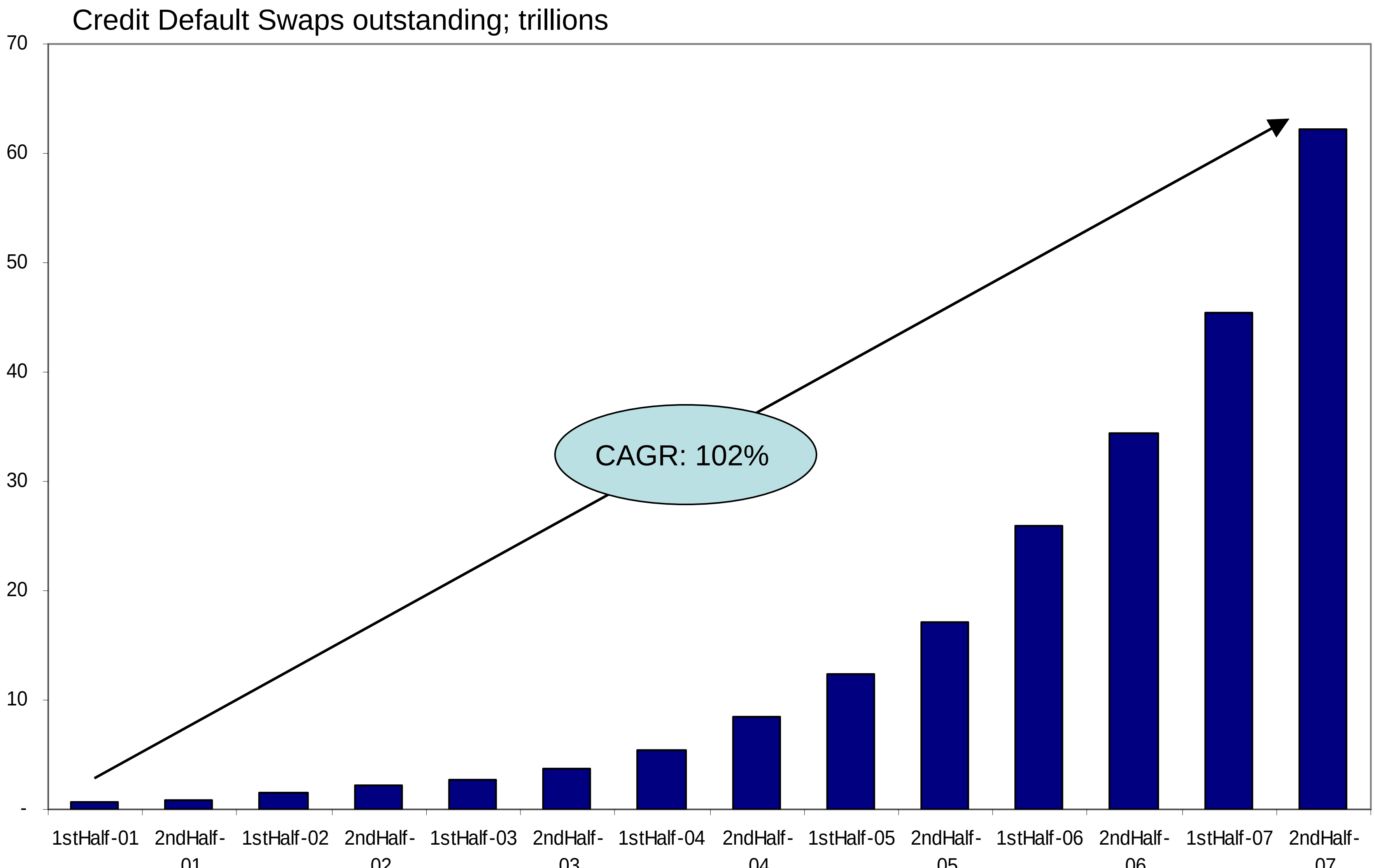
Lenders moved into Riskier Lending—"reaching for yield"—as the cost of short term borrowing increased. Much of the Lending was to those Seeking Cash for Other Spending, or Buying Property for Resale

Interest-Only and Negative Amortization Share of Total Purchase Mortgage Originations: 2000-2006; percent



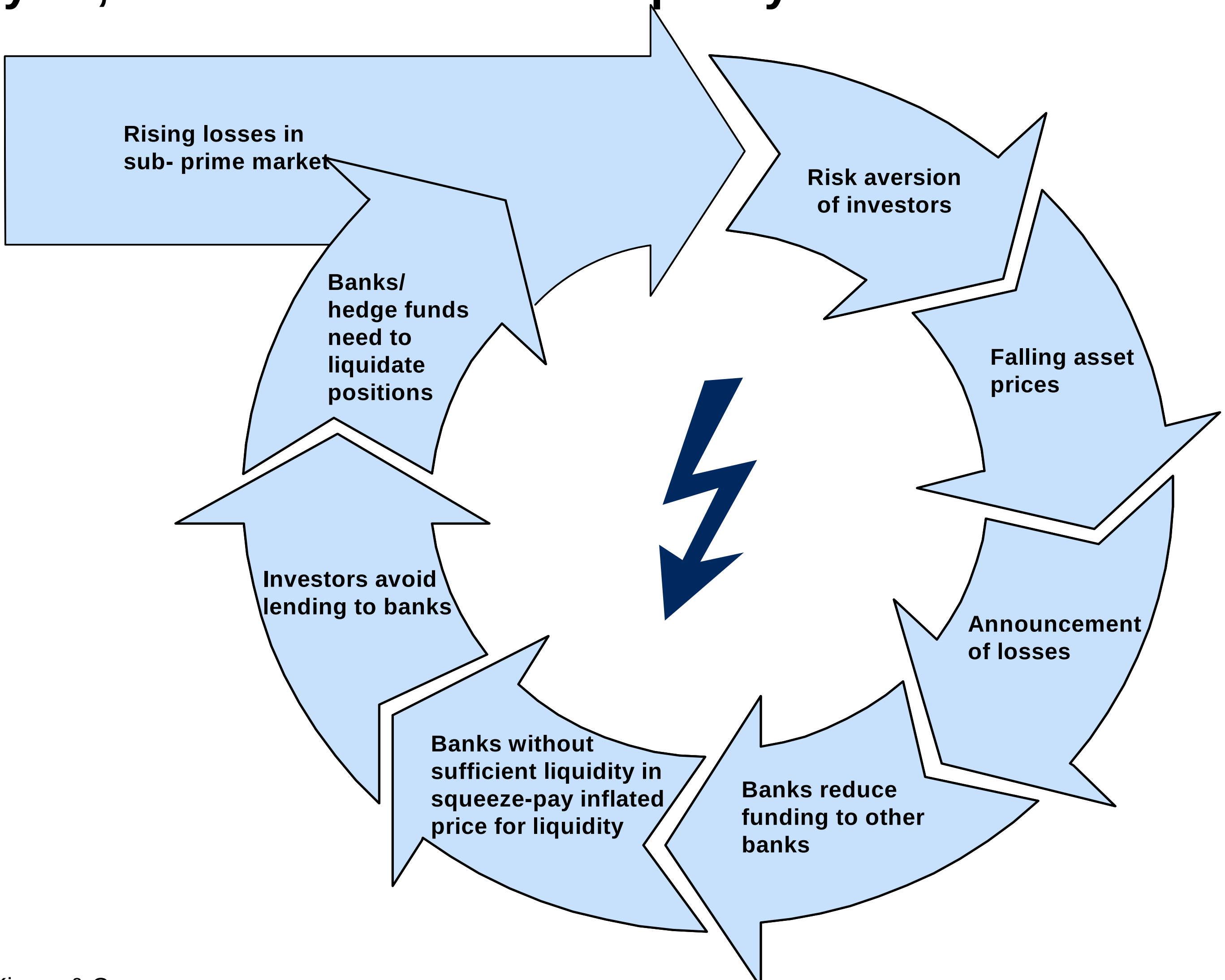
Source: Credit Suisse; LoanPerformance

Credit Default Swaps, Originally Used to Provide Insurance Against Default on Mortgage-Backed Securities and CDO's, Became Trading Instruments for Hedge Funds and I-Banks. Sellers of CDS did not have the Capital to Cover a Broad Market Downturn (AIG).



Source: ISDA

When the defaults started, this made financial institutions reluctant to lend to each other. Intermediaries could not roll over their short-term borrowing. Markets started to freeze up world-wide. There was a vicious cycle, which drove further illiquidity.



Source: McKinsey & Company

What to do? Financial Instruments and Institutions Should Be More Transparent

- Mortgages:
  - simpler disclosures and counseling in advance
  - broader and stronger restrictions under HOEPA
  - federal oversight of state regulation of originators
- Asset-backed securities: report on underlying assets
- Credit ratings agencies:
  - separate advising and rating functions
  - greater clarity in comparing ratings across asset classes
  - report on agencies' track records
  - disclose limitations of ratings for newer instruments
- Derivatives: standardize and trade on exchanges

What to do? Financial Institutions Should be less leveraged and more liquid

- Banks should have more capital
  - Required issuance of uninsured subordinated debt (Litan)
  - Required purchase of capital insurance (Kashyap, Rajan, Stein)
- Banks should be more liquid
  - They will always be highly leveraged, so it matters how their debt liabilities are structured. The focus should be on maturity mismatches on the balance sheets of all institutions. Liquidity requirements, perhaps (Elmendorf)
- For bond insurers: higher capital requirements
- For other insurers: an optional system of federal chartering and regulation aimed at safety and soundness.

What to do? Financial Institutions Should Be Supervised and Regulated More Effectively, Including a Systemic Risk Approach

- There were lots of rules and lots of regulators, but they did not prevent the crisis. Hire better people and pay them more. They must oversee risk management practices and do more to supervise underwriting standards.
- The regulatory structure is complex and cumbersome and should be consolidated.
- As the probability of an asset price bubble increases (dot com stocks or housing), the FED should tighten monetary policy and regulators should tighten lending standards.
- The FED must consider systemic risks, particularly those arising when the assets of one financial institution are the liabilities of another.

Brookings Research on the Financial Crisis

- Baily, Elmendorf and Litan (2008). “The Great Credit Squeeze: How it Happened, and How to Prevent Another.”
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- Baily and Litan (2008). “A Brief Guide to Fixing Finance.”
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