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ECONOMISTS' OUTLOOK

A Brief Look at the Sub-Prime Crisis: Was it a Regular Business Cycle, the Result of Lax Supervision and/or a Regulatory Failure?

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Introduction

> 'Not since the beginning of the First World War has our banking system been so close to collapse.'[1]

The global economy has been in an interesting position over the last year. Many economies of all types, sizes and origins are in fear of, or actually in, recession. The terms 'credit-crunch' and 'sub-prime' are common parlance referred to on a daily basis by newspapers and common laity. This is a testament as to the force of sentiments held in common thought. Financial markets are built around risk and uncertainty. These markets are important because they handle much of the money in the economy. There is undeniably a need for regulation because of the 'special economic role of money and the uncertainty associated with it.'[2] There is a great deal of contention over issues to do with how the current situation came about. The hunt has begun for those responsible. Critics and academics are pointing the finger of causal blame in all directions. Very few players in the financial sector have escaped criticism in some form.

The process of rationalising the various contributory factors is a complex task. To make any sense of the forces involved it is necessary to analyse and consider the build-up of the crisis from various perspectives. It soon becomes apparent that regulators were behind the trend in the markets. Regulatory approaches, monetary policies, macroeconomic factors and the general attitude towards debt combined to form the recipe for the current crisis. It is clear that it is the culmination of these various factors that has led to the current crisis and it is impossible to put the blame on one head. This paper shall attempt to describe the various contributory macroeconomic and regulatory factors, to assess their interactions and to highlight their importance.

The sub-prime mortgage

The term 'sub-prime' in this context refers to a class of debt issued by banks that is essentially more risky to those who were calculated to be less capable of affording repayments. In 2004 the interest rates in the US reached an all time low of 1%. This was a monetary policy designed to inject large amounts of money into the economy by increasing the supply. In simple economic terms, as the cost of borrowing decreases the quantity demanded will increase. With money being cheap and plentiful, banks could better afford to issue sub-prime products. Lenders began to issue more sub-prime mortgages with a high calculated risk, carrying higher than average chargeable interest rates. As the economy was doing very well and the value of property was consistently increasing there were very few defaults. If one were in difficulty it was possible to simply re-mortgage the property, taking advantage of the increased value of the property. The reduced frequency of defaults meant that the banks were making abnormal profits on sub-prime products, encouraging a higher level of interbank competition as they all wanted a piece of the action.

A state of predatory lending and intense competition began to take hold. Price competition resulted in lower interest charges on these mortgage products, reducing the cost of repayments and improving the attractiveness of the offer to would-be sub-prime home owners. Banks also competed in terms of product compilation. Mortgagor's became more aggressive and creative, inventing new products, such as variable rate trackers and interest only. From the borrowers perspective, this was a very attractive situation and they took advantage of it.

Notes

1 Mervyn King, speech given on Tuesday 21 October 2008, to the CBI, Institute of Directors, Leeds Chamber of Commerce and Yorkshire Forward at the Royal Armouries, Leeds.

2 Sheila C. Dow, 'Why the Banking System Should be Regulated', (1996) 436 *The Economic Journal* 698-707.

The birth of the 'originate-to-distribute' model of business.

From the lenders' perspective, the traditional mode of mortgage lending (originate and hold),[3] where the bank holds the risk of default and receives interest and principal payments, was largely abandoned because it meant that the number of loans that could be issued was limited to the amount of money held on deposit. The limits imposed by this meant that banks quickly operated at their maximum production possibility. They needed to find a way to push out their production possibility frontier so that they could continue to compete and grow. The banks decided to securitise the sub prime debt, so as to give a liquid transferable asset. The sub prime debts were mixed together with prime and near-prime debt to form collateralised debt obligations (CDOs).[4] These securities were thus sold on to free capital for the issuing bank to issue new loans. The risk, was therefore passed on to a third party purchaser of the security, increasing the risk spread in issuing debt. This was the 'originate and distribute model',[5] 'by which banks originate loans and then distribute the underlying risk to a pool of investors by means of dedicated instruments.'[6]

Much of this trading was carried out by structured investment vehicles (SIVs),[7] which were off-balance sheet entities and to a large degree separate from a regulatory and financing standpoint. SIVs took out short term debt to purchase long term mortgage securities which would then be re-distributed at a profit, facilitating the repayment of the short term credit. Good credit ratings allowed the SIVs to borrow at low interest and to lend at a much higher interest. The use of SIVs allowed many forms of financing with very little capital requirements that would otherwise have not been permitted.

The melting point

Interest rates in the US later rose and the value of homes began to fall. Some mortgagees with 100% LTV mortgages found themselves to be in a state of negative equity. As the introductory period began to come to an end the cost of repayments increased enormously. Many people were faced with costs higher than they had originally anticipated at the time of taking the agreement and found themselves unable to afford their agreed obligations. There was also no longer the possibility of relying on the residual equitable value in the property for refinancing the mortgage. The situation was then that borrowers had to make their payments or default. There was no longer an easy way out. The cumulative effect of these factors was that more mortgage agreements were defaulted on more frequently.

With the sudden realisation that the sub prime mortgages had been under priced in relation to the level of risk and that the collateral base was undermined the value of the debts as securities dropped. Because of the complicated packages of securities compiled by the banks, it was very difficult to know which contained sub prime debt. As potential losses were feared to be vast and as banks did not disclose what losses they had made or what securities they owned there was a great deal of suspicion in financial markets. Banks were more reluctant to lend to each other, leading to an increase in the cost of borrowing and causing what is known as a 'credit crunch', which creates a liquidity crisis.

The market for securities essentially evaporated overnight as it was impossible to see what was infected by the contagion. The value of mortgage backed securities held by the banks was non-testable. Without willing buyers it is impossible to test the value of the securities. Any sale would have to be made at a heavily discounted price. The cumulative result was that there were vast black holes left in the banks' balance sheets.

The high degree of reliance by banks on short term credit meant that it was especially harmful. The majority of banks were not insolvent, but rather illiquid. They faced the possible collapse due to the lack of availability of credit. The State had to intervene, injecting money to try and resolve the issue, taking the liquidity pressure off the banks.

Is this a normal business cycle?

If one were to look through economic spectacles alone then it would be hard to say that this was not a regular business cycle, the series of recurring fluctuations in

Notes

3 William Buiter (Maverecon), 'Lessons from the Financial Crisis Part 1', *Financial Times* website, 26 October 2007, available at: <blogs.ft.com/maverecon/2007/10/lessons-from-thhtml/> [accessed 1 January 2009].

4 CDOs are constituted of fixed income assets divided into different tranches. Senior tranches were rated AAA, Mezzanine tranches rated AA–BB, and equity tranches were unrated. Losses were applied in reverse order of seniority and so junior tranches offered higher coupons to compensate for the added default risk. The overall result was that sub prime debt, when packaged in a CDO, became a higher grade investment stock allowing the sale to financial conglomerates who would otherwise be barred from purchasing such a low grade debt.

5 William Buiter (Maverecon), 'Lessons from the Financial Crisis Part 1', *Financial Times* website, 26 October 2007, available at: <blogs.ft.com/maverecon/2007/10/lessons-from-thhtml/> [accessed 1 January 2009].

6 Laurent Clerc, 'A Primer on the Sub Prime Crisis', Banque de France, Financial Stability Directorate. Occasional Papers, No. 4. February 2008.

7 *Ibid.*

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economic activities. These fluctuations consist of the cyclical processes of growth, recession and recovery. The 'business cycle' can be observed in economic history as a series of booms and busts. The question is therefore whether the current crisis is a continuation of this cycle, which many hoped was a thing of the past, or whether it is something truly different.

Rogoff and Reinhart[8] believe that there 'are stunning qualitative and quantitative parallels across a number of standard financial crisis indicators'[9] and that 'the global dimension of the current crisis is neither new nor unique to this episode.'[10] They draw many similarities between the current crisis and 18 other post second world war crises. The run up is very similar to those. A credit crunch is not a new phenomenon and banks do often collapse internationally. The constituent parts of the current crisis appear to be no different and therefore not an irregular event, thus suggesting that it is no more than a regular business cycle.

House prices in real terms increased by 100% between 1995 and 2006. Few would doubt that such an increase in real prices would be the perfect representative definition of a price bubble. Alan Greenspan suggested that 'bubbles cannot be safely diffused by monetary policy or other policy initiatives before the speculative fever breaks on its own.'[11] This suggests that there is some form of underlying game theory logic to bubbles, i.e. a certain inevitability. A reliance by Greenspan on such a factor suggests that he does believe the crisis to be a regular business cycle.

Supervisors in hindsight have also placed blame on factors such as the Asian saving glut.[12] Alan Greenspan is very keen to clear his name and to be remembered as favourably as he was before this crisis. Taylor,[13] for example, wrote about how well Greenspan had handled himself in office with respect to his judgement of monetary policy issues. Greenspan blames it on the inequalities in the international markets, especially the Asian savings glut and the massive sovereign wealth funds. The idea is that there was a seemingly inexhaustible supply of money from the sovereign wealth funds into the money markets, which pushed the international bond rates far below normal. Such powerful factors would be seemingly unstoppable, rendering him not to blame.

However, Rogoff and Reinhart do acknowledge that unlike many other crises that followed periods of 'liberalization of financial markets',[14] there had recently been no express liberalisation, but instead a 'de facto liberalization'[15] of financial markets. 'New unregulated, or lightly regulated, financial entities have come to play a much larger role in the financial system, undoubtedly enhancing stability against some kinds of shocks, but possibly increasing vulnerabilities against others.'[16] This suggests that although the financial system has been well regulated to protect against certain shocks, it has inadvertently led to new threats. Clerc[17] suggests that 'dis-intermediation, deregulation and securitisation … have not only profoundly changed the financial landscape, but also the contours of liquidity.'[18] Whether or not this crisis is a regular business cycle it is clear that elements of regulation and supervision deserve criticism.

Regulatory Failure and the pro-cyclical effects of Basel II

Regulation here means the rules governing behaviour that are prescribed by regulators in their control of the financial markets. Regulation of the mortgage market in the US occurs at state and federal levels. 'The mortgage broker industry is regulated by 10 federal laws, five federal enforcement agencies and over 49 state laws or licensing boards'.[19] There was clearly a great volume of regulations.

The originate and distribute model has been widely acclaimed for its ability to create greater efficiency in financial markets. A Report to the Select Committee in the UK has even stated that it is here to stay. It is a

Notes

8 Carmen M. Reinhart and Kenneth S. Rogoff, 'Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historic Comparison', NBER Working Paper Series. Working paper 13761, January 2008.

9 *Ibid.*

10 *Ibid.*

11 Alan Greenspan, 'The Roots of the Mortgage Crisis', *The Wall Street Journal*, 12 December 2007, available at: <online.wsj.com/article/SB119741050259621811.html?mod=opinion_main_commentaries> [accessed 12 December 2008].

12 As considered by Martin Wolf, in 'Asia's Revenge', *Financial Times*, 8 October 2008.

13 John B. Taylor, 'Lessons Learned From the Greenspan Era', Stanford, August 2005, available at: <www.stanford.edu/~johntayl/JacksonHole2005.pdf>.

14 Carmen M. Reinhart and Kenneth S. Rogoff, 'Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historic Comparison', NBER Working Paper Series. Working paper 13761, January 2008.

15 *Ibid.*

16 *Ibid.*

17 Laurent Clerc, 'A Primer on the Sub Prime Crisis', Banque de France, Financial Stability Directorate, Occasional Papers, No. 4. February 2008.

18 *Ibid.*

19 National Association of Mortgage Brokers website: <www.namb.org/namb/Mission.asp> [accessed 1 January 2009].

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'natural and intelligent way to diversify risk and to open up capital markets.'[20] However Clerc highlights that the originate and distribute model led to the situation that 'a significant source of liquidity and credit lies outside the banking system. Besides banks-mediated liquidity, traditionally measured by monetary and credit aggregates, there is a second and growing component which depends on the amount of credit non-bank financial intermediaries are willing to extend to each other.'[21] The originate and distribute model results in a radically different market and carries with it different issues to the traditional model. There is a decrease in the quality of debts issued as credit issuers intend to 'pass the parcel'. This is a radical change and regulations did not adapt quickly enough to keep up, the old rules were not updated to take account of the changes in the way the game was played. Regulations that are adopted have a great impact on the way in which the crisis impacts[22] and must be drafted effectively and precisely.

A good place to start with regulatory failure is that of Basel II. Several scholars have highlighted the involvement of Basel II in the bringing about of the originate and distribute business model. That model was largely dependent upon the input of the CRA's. Basel II provided the regulatory framework through which pro-cyclical practices developed. Weber and Darbellay[23] argue that the 'explicit recognition of CRAs'[24] in Basel II 'giving a regulatory task to private entities'[25] gave the root cause for changes in the credit rating business. Their 'traditional [role] as information intermediaries to improve the efficiency of securities markets by increasing the transparency of securities ... reducing information asymmetries between investors and issuers'[26] changes. Their role becomes more of a 'quasi regulatory function',[27] 'assessing the credit quality of a wide range of securities'.[28] They state that 'critics even mention a shift from the business of providing valuable credit information to the far more lucrative business of selling regulatory licenses'.[29]

As their involvement becomes part of regulation they are increasingly employed by the issuers, as opposed traditionally to being employed by the prospective investors. Thus emerges a possible conflict of interests from an 'issuer pays model'. CRAs, being private firms operating in a market, compete with each other for business. They are often employed by the issuers from whom they are supposed to protect the prospective purchasers. If they do not give a favourable credit rating then they will not be hired by the issuer. This is similar to the conflict of interest that was seen during the Enron crisis, where auditors were giving inaccurate and favourable reports in order to get lucrative contracts.

Repullo and Suarez,[30] writing just before the outbreak of the crisis believed at the time that 'the practical incidence of the pro-cyclicality problem is likely to be small if not negligible.'[31] Unfortunately the crisis proved many of their points, and showed that the practical incidence was far greater than they had anticipated, albeit for different reasons. Weber and Darbellay conclude in their article that 'the actual regulatory system does not satisfactorily address risks in the banking sector. ... One of the most important problems is related to the use of credit ratings in banking regulation.'[32] They believe that it is not possible to prevent future crises with absolute certainty, but 'the negative consequences of these crises would be reduced in a significant way if the ratings-based regulation were replaced by more appropriate policies.'[33] This supports the view that perhaps the crisis is not a common business cycle, but is the result of regulatory mistakes creating the situation in which market forces transformed the financial markets so different from that which the regulations were designed for. If it were not for the heavy reliance on credit ratings agencies in bank capital requirements

Notes

20 Ryan Barnes, 'Fuel that Fed the Sub-Prime Meltdown', *Investopedia*: <www.investopedia.com/articles/07/subprime-overview.asp> [accessed 12 December 2008].

21 Laurent Clerc, 'A Primer on the Sub Prime Crisis', Banque de France, Financial Stability Directorate, Occasional Papers, No. 4. February 2008, p. 1.

22 Hui Tong and Shang-Jin Wei, 'Real Effects of the Sub Prime Mortgage Crisis: Is it a Demand or a Finance Shock?', IMF Working Paper WP/08/186, July 2008.

23 Rolf H. Weber and Aline Darbellay, 'The Regulatory Use of Credit Ratings in Bank Capital Requirement Regulations' (2008) 10:1 *Journal of Banking Regulation* 1745-6452.

24 *Ibid.*

25 *Ibid.*

26 *Ibid.*

27 *Ibid.*

28 *Ibid.*

29 *Ibid.*

30 Rafael Repullo and Javier Suarez, 'The Procyclical Effects of Basel II [Preliminary Draft]'. CEMFI, March 2007, available at: <www.carloalberto.org/files/repullo-procyclicality.pdf> [accessed 12 December 2008]. (Revised in June 2008: Rafael Repullo and Javier Suarez, 'The Procyclical Effects of Basel II', Social Science Research Network (June 2008), available at: <ssrn.com/abstract=1146826>.)

31 *Ibid.*

32 Rolf H. Weber and Aline Darbellay, 'The Regulatory Use of Credit Ratings in Bank Capital Requirement Regulations' (2008) 10:1 *Journal of Banking Regulation* 1745-6452.

33 *Ibid.*

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then the originate and distribute business model would never have come into being in quite the same dangerous way regarding sub prime debt.

Lax supervision

Whether or not supervision was 'lax' is a question of standard and whether the approach taken was adequate and proper, a question of relativity as one would have to judge against the standards of a competent authority performing its function effectively and efficiently. Supervision in this context means the actual process of oversight and monitoring of financial markets. One of the roles of regulators is actively to monitor the markets to ensure that regulations are adhered to. Lax supervision may contribute to the problem because it may mean that rules are not enforced, resulting in a lack of uniformity in the market. Also the responsiveness of regulation depends a great deal upon the observations and experience of the supervisor. In financial markets this may mean that there are higher risks as market actors are able to bend the rules. It is good to have appropriate regulations in place to govern the market, but they are potentially useless if they are not enforced properly by a competent authority. It is also impossible to identify any shortcomings unless rules are applied and markets supervised properly. Successful financial market supervision consists of identification, assessment and risk management, maintaining adequate consumer protection and maintenance of market confidence.[34]

In hindsight it may be easy to say that surely the regulators must have noticed that loan to valuation ratios of 125% being issued to sub prime borrowers was a recipe for disaster. In the build up to the crisis this was happening all over the world. Anna Schwartz,[35] one of many critics, clearly believes that lax supervision has been a major contributory factor in the current crisis as she states: 'there never would have been a sub-prime mortgage crisis if the Fed had been alert ... this is something Alan Greenspan must answer for ...'.[36] This suggests that as regulations were clearly poor the Fed must have been asleep, i.e. not performing sufficiently well. Not only did the Fed not keep up with markets in terms of regulation they also lowered interest rates very aggressively for a sustained period of time. Schwartz believes that Greenspan's 'premature monetary policy'[37] was heavily to blame as it was 'too accommodative'[38] and fuelled the property price bubble. She believes that unless the Fed own up to their mistakes there will be no improvement in market confidence. Objectively, the supervisory role was not carried out properly and the authorities were well behind where the markets had gone.

The motivation behind supervision is a key factor. There was a great deal of complacency amongst the supervisors internationally. In the UK, for example, financial institutions were evidently given regulatory holidays.[39] As there was a feeling of complacency there was little motivation for intervention. It was easier to attribute the situation to improvements in efficiency resulting from originate and distribute models and other creative financial innovations than to investigate in a more paranoid/cautious way the imperfections in the markets.

Alan Greenspan should be well aware of the effects that the supervisor has on the markets, especially after his 'irrational exuberance' speech[40] and the resulting panic he caused in 1996.

Greenspan has admitted in his memoirs that he was motivated also by the political endeavours of President Clinton. He states that: 'I was aware that the loosening of mortgage credit terms for sub-prime borrowers would increase financial risk and that subsidized home ownership initiatives distort market outcomes. But I believed then, as now, that the benefits of broadened home ownership are worth the risk.'[41] This political dimension of motivation detracts from the technical task of ensuring that the markets performed properly, acting as a harmful distraction from their central task.

Another important aspect to consider is that because of the originate and distribute model there was a surge in the number of mortgage issuers. In 2005 there were 56,000 mortgage issuers in the United States.[42] This is a vast number of entities to supervise, requiring a great deal of resources to do properly. These did not increase with the same vigour. 'Problems of monitoring

Notes

34 Sheila C. Dow, 'Why the Banking System Should be Regulated (1996) 436 *The Economic Journal* 698-707.

35 'Anna Schwartz blames Fed for the sub prime crisis', *The Daily Telegraph*, interview with Anna Schwartz, available at: <www.telegraph.co.uk/money/main.jhtmlxml=/money/2008/01/13/ccschwartz113.xml> [accessed 12 December 2008].

36 *Ibid.*

37 *Ibid.*

38 *Ibid.*

39 See the Executive Summary on the supervision of Northern Rock, FSA.

40 Remarks by Chairman Alan Greenspan, at the annual dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington DC, 5 December 1996.

41 Alan Greenspan, *The Age of Turbulence* (Penguin Press, 2007) p. 233.

42 Wholesale Access Mortgage Research and Consulting, New Research About Mortgage Brokers (2005), available at: <accessmtgresearch.com/?p=25 [accessed 12 January 2009].

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compliance and enforcement are exacerbated by the organisational context',[43] meaning that adequate supervision became almost impossible.

The reasons why regulations did not catch up may be due to market supervisors not being 'awake', but it may also be due to them genuinely not understanding the way in which the market had changed. Many predicted problems associated with issuing risky debt, but few foresaw the way in which the contagion would spread throughout the world financial markets. Maybe this misunderstanding can also be attributed to the 'lax' supervision of the markets.

Conclusion

> 'Like the weather, it was foreseeable; unlike the weather, it was avoidable.'[44]

The question of 'who was to blame?' is effectively a moot point. In reality there is no single reason for the crisis. It is the result of a cumulation of various factors. There are interconnected elements of regulatory failure, supervisory failure and cyclical business factors all contributing to the equation. The financial markets system is one built on trust and confidence, which take a long time to develop. Possibly regulation can help, but is not sufficient in itself.

It is highly likely that there will be a relatively highly regulated environment to come, and there are many challenges faced by the regulators. With governments recapitalising banks it is almost certainly going to come with conditions. In order for there to be an improvement in the situation there must be elements of market self-correction, effective regulation and government intervention. More regulation in itself is not necessarily the answer as the roots of the problems faced today have moved far beyond their causes. What is needed is effective adjustments to regulation. In the American press many are fearful of the possible effects of regulation to come. NAFCU have stated one of their main aims in 2009 is to 'ensure that legislative and regulatory efforts do not bring unintended consequences and burdens to credit union operations and member service'.[45] The Fed should not repeat the shortcomings of the great depression by causing even more problems.

Problems that resulted from complacency are a common undertone throughout various aspects of the entire crisis. 'It became unfashionable in the main-stream approach to worry about the quantities of money and credit in the economy. So long as inflation expectations remained well anchored, the conventional wisdom said that monitoring such quantities could not improve the conduct of monetary policy. But, the experience of the past few years shows that this view is inadequate.'[46] It may be possible to come to conclude that the regulation should be conducted with a degree of paranoia. This was certainly not the case with legislation like Basel II or the monetary policies of Alan Greenspan, as has been observed by Anna Schwartz et al. Such lessons may be learnt from the Canadian method of banking regulation, assuming that banks 'will' fail, rather than that they 'will not' fail. This seemingly paranoid and cautious approach to legislation and regulation has protected the system from many of the shocks of the sub-prime crisis. The Canadian markets have had little contact with the contagion. This is likely to be because their system is built, designed and regulated in such a way as to specifically be able to deal with bank failures. The large financial economies of the USA and UK do not possess the same emphasis in their approach and have thus suffered greatly.[47]

> 'You're right, we did it. We're very sorry. But thanks to you, we won't do it again.'[48]

Notes

43 Robert Baldwin and Julia Black, 'Really Responsive Regulation' (2008) 71:1 *The Modern Law Review* 59.

44 National Fair Housing Alliance, *2008 Fair Housing Trends Report*, p. 7.

45 The National Association of Federal Credit Union, press release 30 December 2008, available at: <www.knowledgeplex.org/news/2842031.html> [accessed 1 January 2009].

46 Speech by Timothy Beasley, 'Some Current Issues in UK Monetary Policy', Bank of England. UBS Conference Centre, London, 28 October 2008.

47 These points can be evidenced partly by considering the different approaches taken by these states towards their deposit insurance provisions. In the UK, for example, the FSCS never really played any significant role prior to the crisis; it was always in existence as a mere formality (as it's role was very limited with regard to supervision and regulation). In Canada the CDIC was incorporated in the regulatory structure in a much more appropriate manner, so as to be better prepared in the event of a bank failure. For more information on the subject of deposit insurance, see Campbell, Labrosse, Mayes and Singh (eds), *Deposit Insurance* (Palgrave Macmillan, 2007).

48 Remarks by Ben S. Bernanke at the conference to honour Milton Friedman, 8 November 2002.

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