Whither now regulation?

It is still too early to understand the full contours of the sub-prime crisis and the extent of the damage it has done. Nevertheless, what tentative conclusions should we draw about its causes, and are the implications for regulators?

The starting point for any analysis of the crisis has to be the so called “savings glut” - the worldwide excess in desired savings over realized investment over the last few years, the resulting low real interest rates, and the rise in asset prices, especially housing. The U.S. was not alone in this. Housing prices have reached higher values relative to rent or incomes in Ireland, Spain, the Netherlands and the United Kingdom, for example.

But the U.S. went further in financial innovation. With steadily rising housing prices, easy financing brought more low-income households into the housing market. There was some logic to the lending, and it went something like this: “With such a strong housing market, all I need is to get this buyer into the house. If the loan has low “teaser” rates she has to pay very little over the first few months. By the time she has to pay anything significant, the house will have appreciated 10 percent, and she will have the equity to refinance or make future payments.”

Indeed, credit quality mattered little. If the buyer could not make even the low initial payments, the lender could repossess the house, sell it quickly in the hot market, recouping any losses through the price appreciation. In short, the continuously rising house prices and housing market liquidity fed on each other.

And so it went till the Federal Reserve started raising rates. With fewer buyers able to afford normal mortgages, the first reaction of lenders was to increase the volume of exotic
loans so as to keep the buyers coming. But eventually houses stayed on the market longer
and prices started falling. As more teaser rates started resetting higher, more buyers, with
negative equity in the house, started defaulting. Given that repossessed houses now could not
be sold easily, the underlying credit quality of buyers – whether they had a job, whether they
had income, whether they had assets, started mattering, for that would indicate whether they
were liable to default.

Meanwhile, in financial markets, the original mortgage had been bundled into a pool,
and then securities of different seniority sold against it. Financial engineers further bundled
the securities sold by the mortgage pools into securities pools, and sold claims against them,
and so on. Thus were born the CDO, the CDO squared… Rating agencies went along
certifying senior tranches as of the highest credit rating, even though they had little sense of
their default properties. And because nearly everyone was paying, it did not matter.

Why were these complex assets created? Go back to the savings glut. Financial
institutions in countries with excess savings like Germany and Japan were looking to invest
their foreign exchange earnings, while pension funds and insurance funds in the U.S. were
looking for higher yielding long term paper to match their long term liabilities. Many of these
institutions were constrained to invest in high quality debt instruments. The highly rated
tranches of mortgage backed securities of CDOs were exactly what they wanted, especially if
the AAA tranche of the CDO paid 200 basis points above corporate AAAs. Of course, there
is an old adage in finance – there is no return without risk – but this was forgotten in the
frenzied search for yield.

Given the plentiful financing, the demand for highly rated bonds paying above market
rates was expanded by other strategies. For example, the oldest investment strategy in the
book is borrowing short term and investing in longer term assets – the strategy followed by banks in setting up special investment vehicles or by Northern Rock, the UK bank that nearly failed. Again, this worked so long as finance continued to be available, and itself created more demand for exotic securities.

As liquidity drained from the housing market, everything changed. Securitized mortgage pools were easy to understand and undifferentiated when the housing market was liquid – they all had low risk. But as liquidity started drying up and defaults increased, pools became differentiated based on how careful the originator had been, how well documented the loans were, who they were to, etc. Information started mattering more and it was hard to get at. Ratings became suspect. This immediately created a problem for those who owned claims on the mortgage pools, and wanted to borrow against, or sell them. In the same way as a used car salesman has to sell a car at a significant discount because the buyer suspects the car may be a lemon, once the mortgage pool has become differentiated, arm’s length buyers like foreigners or pension funds are reluctant to buy, and lenders are unwilling to lend, without knowing much more.

The securities issued by CDOs became doubly hard to value, because not only were they subject to the same underlying information problems besetting mortgages, but also because they were leveraged claims on these assets, with much more complicated default properties. Thus illiquidity in the housing market created information risk, which coupled with complexity risk, destroyed liquidity for asset backed securities in the financial market.

Many of the investors in the market did not have the capability of going beyond the now unreliable ratings to ascertain quality. Unfortunately, the obvious investors who could,
the large money center banks, were preparing their balance sheets to take on other commitments that might devolve on them. And thus credit markets became paralyzed.

What lessons can we draw? First, while abuses did take place, perhaps more than we know of at present, the central problem was overestimating liquidity in the housing market and in financial markets. Optimism is not a sin. But if optimism is fueled by poor incentives, it does become a regulatory problem.

Some have focused on the conflicts of interest at the mortgage originators or rating agencies. But one should not give buyers a free pass. Why did they not worry they were taking more risk when they got hundreds of basis points more for CDO tranches than for equivalently rated corporate securities? How much of the incentive to search for yield was driven by the low level of interest rates, and how much by compensation structures that emphasize short-term return over long term risk? How much were bureaucratic pension fund managers, who bought anything as long as they were covered by the rating, to blame?

Second, everyone, not just regulated banks, consume liquidity. Central banks need to monitor more entities to ensure private sector liquidity buffers are adequate. As the commercial paper market dried up following the Russian crisis in 1998, commercial banks could re-intermediate as commercial paper investors re-deposited their money in banks and banks lent on to the former commercial paper borrowers. This time around, bank balance sheets appeared to have less space as banks joined the frenzied herd making illiquid loans. Should central banks encourage more private liquidity buffers, and how will they pay financial firms for maintaining it?

Third, capital regulation seems, in part, to have played a perverse role – encouraging banks to leave commitments off balance sheet and even disguising them. And it has done
little for liquidity provision, perhaps even restraining banks from taking assets on their
balance sheet in the liquidity crisis. Even as we start introducing Basel II, does much of it
need to be rethought?

In sum, regulators should worry about incentives, liquidity, and the perverse impact
of past regulations. While obeying the diktat, “First do no harm”, they need to seriously
reexamine their approach in the light of the incoming evidence.

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