

Commissioner meeting 9/28/10

Important? Major? Minor? Causal? Contributor?

Primary? Secondary? Minor?

The housing bubble and bust was a primary cause the financial crisis.

What was elemental in causing the housing bubble and bust?

Declining standards led to more credit being extended; declining lending standards by bringing riskier borrowers and lower quality loans into the system. (Doug: yes declining standards – or, increased access to the mortgage market – led to higher home prices, but other important factors led to an increase in home prices as well. Lending standards are not a “but for”. The actual creation of the housing bubble is not a central question. The question is how the bursting caused the crisis. John: we need to think about why we had a bubble. Heather: the fact that they were poorly done, means that the assets were based on something that ultimately failed. If poor loans hadn’t been in the system, wouldn’t have been on the balance sheets). Disagreement – contributing or causal factor in the bubble and disagreement in its role in the bursting of the bubble and the effect of the bursting of the bubble on the rest of the financial system.

To do: define different kinds of mortgage fraud. Some commissioners believe it was contributory.

Additionally, loans – particularly those in the securitization chain – were misrepresented and were actually worse than the underwriting standards as represented. This caused a lack of appreciation of risk in the mortgage-related assets. This unappreciated decline in mortgage standards was a primary cause of the financial crisis, by leading to panic and larger-than-expected defaults. The lack of due diligence represents bad risk management.

Regulation of the mortgage industry was a cause of the bubble

--contributory. John: Who was responsible for regulating the mortgage market overall. Could the structure of actually regulated the market? Heather points out that appraisal regulations changed (apparently state specific). Changes undermined credit standards. Broader than just regulation of credit standards. Other regulations covered the housing market. Brooksley: the Fed failed to step in to implement and enforce underwriting standards. Doug: mixed bag of regulators. Fed did think about it, and decided not to change the standards for a while. Were there parts of the mortgage system totally unregulated?

Fed: Bad policy judgment and it was causal (Doug: contributory) to the crisis (bubble).

The fact that the Fed did not act meant that failures of regulation and enforcement in other parts of the system mattered and helped to cause (DHE: contribute) the bubble.

Credit rating agencies

Enablers in securitization. Got geographic correlation wrong and correlation between economy and housing market wrong. They are a *but for*. In many cases the label was essential for whether the security was held.

Securitization

John and Brooksley: Helium in the balloon and causal of the bubble. Doug disagrees. The securitization engine meant more mortgages were created. Doug: securitization around for decades. Byron: But, securitization help to push out mortgage access to more people.

A great deal of money (\$xx) pushed its way into the mortgage market between 200xx and 200xx, which was a primary cause of the housing bubble. A primary mechanism to push this money into the market was securitization.

Agreement that securitization helped to cause the financial crisis. Utter opacity. Rating agencies enabled. They were so complicated that we needed rating agencies to value them and they did a bad job. The complex securities spread risk, leverage, and exposure. What went into the system was not represented properly and investors/firms/participants failed to do due diligence.

Credit derivatives: Credit enhancement facilitated securitization (a primary mechanism getting money into the mortgage market). Increased risk, leverage, and exposure. Synthetics amplified risks. Opacity. Concentrated risk. Particularly important at the end helped to spur the panic.

To do: how many of the structured products had CDS attached to them.

GSEs: The GSEs did not cause the crisis. They are another institution that transferred mortgage risk to their debt and equity holders and ultimately the taxpayer. Because of their scale, that mattered. At the margin—in a way that was not material, they helped to put money into the riskier parts of the market because of the AHG. They also helped (particularly at the end) to increase demand for PLS (which put money into the mortgage market, which pushed up the housing bubble).

Their failure fed the panic. Their assets could be held in unlimited amounts by banks (serious policy error). (Using the bazooka: The don't worry, and then, worry) Made really bad risk management decisions particularly late in bubble. This transferring of risk was not completely transparent to the market and part of the failure in risk management. Disagreement/unknown on why they expanded market share. Thinly capitalized by statute (serious policy error and failure of supervision).
Fundamental error of the business model.

Housing policy: (Doug has no view on housing policy) The CRA and AHGs did not cause the crisis. Role of housing policy is actually broader – it's a cultural effect. Agreement: Homeownership was boosted and hyped, creating cover for bad lending.

Loose monetary policy made borrowing cheap at the short end of the yield curve, which stimulated the economy, which played out partly in increasing demand for housing. Hence, loose monetary policy fed the bubble.

Net international capital flows was one of the primary sources of money that fed the housing bubble. In particular, this money went into AAA assets, which were often housing assets.

Monetary policy created a predictably steep yield curve that increased the profitability of securities arbitrage in capital markets, which helped to push more money into mortgage markets and—without proper risk management or regulation—created increasing risk in capital markets.

Corporate Management and Governance

There was none.

Heather: Wasn't there mismanagement across the spectrum, not just in corporations? Doug: isn't it pervasive. Feels squishy. Maybe just classic bubble. Great moderation. Euphoria. Institutions took on way too much leverage. Not all households were levered. John and others: it was pervasive. Phil: have to be careful. Some consumers, a set of financial institutions (some weren't systemic). John: absolutely have to say that some consumers and investors helped to cause the crisis. Heather: we should focus on financial institutions we studied, those relevant to our mandate.

Did corporations have the incentives to invest in good risk management? Through SOX, only had incentive to prevent fraud. In fact, created an environment where corporations worked to comply with the law and nothing more.

Doug: were there big enough changes? But, compensation structure is essential to risk management. If you have these compensation structure that creates incentives for risk – better have a good risk management system to counterbalance. The compensation structure doesn't matter on its own – it should have been counteracted by prudent risk managements. Flip side, as practices became riskier, compensation practices did not counteract. Compensation practices can improve risk management.

AGREEMENT: Risk management at many systemically important companies was inadequate. These failures helped to cause the crisis (i.e. the firms had irresponsible leverage and did insufficient due diligence on the mortgage-related assets they had exposure to). Things like leverage are inseparable from mismanagement of risk.

AGREEMENT: Poor risk management led to inappropriate compensation results. Compensation structures did not evolve to reflect the changes in the environment in the financial services sector. Environment got riskier and, particularly, bigger (creating big jackpots for example) and compensation structures did not adjust. The business model changed, but the compensation practice did not adjust.

AGREEMENT: Compensation structures create incentives to increase annual revenues and market share in an environment of intense competition, light regulation, and cheap money. For most workers, compensation was short term. (For executives, it was, in part, long term)

AGREEMENT: When firms went public, the compensation structure was too similar to the partnership structure. They kept with same percentage payout. Shareholders did not complain or voice displeasure. They did not vote with their dollars. Commercial banks that were privately held (or had different structures) had to compete for same talent pool. So same structure of compensation.

To what extent do we attribute poor risk management to moral hazard or the expectation of a government backstop? Commissioners: not at all. Not on their minds. Lemmings. Doug: moral hazard in commercial banking sector. Maybe LTCM... Greenspan Put. If things got tough, Alan has our back. Post Bear – too late. Moral hazard but not primary. Heather: put related to investors' perceptions, not firms perceptions. Doug: stress test trimmed by put. End of business cycle. The assumption that business cycle was over was a fundamental driver of risk management/risk decisions.

[Agreement: Inconsistency in bailouts/rescues – Bear, F/F, then Lehman... -- helped to cause the crisis. Then Doug quoted Bernanke, lending into a run, not legal]

Reg and Sup

The regulatory posture contributed to the crisis.

Power to not regulate was not exercised. Why? Bill: because of the environment.

Doug: era that the world was perceived as less volatile. How do you separate a failure to regulate with a failure to perceive that the world is risk? Were they asleep at the switch or did they not appreciate the risks?

Bill: it was a cultural, bipartisan misjudgment of the risks. The regulators also misjudged.

Heather: for whatever reason, they did not regulate and also dismantled regulations.

Doug: sees mortgage, not sure about broader.

Bill: Risks were ignored. Regulations were seen as hurdles and burdens. Failure to utilize regulations. They didn't do their job. And, inadequate regulation. Regulators are creatures of Congress, which had a deregulatory posture. Deregulation because they couldn't lower taxes. System was antiquated. Didn't keep up.

Heather: failure to adequately regulate mortgage origination, failure to evolve regulatory regime as the financial system evolved, derivatives deregulation, GSE. Should hold regulators responsible for understanding the state of play. Should have understood the market. What did they know and when did they know it?

Doug: would take off derivatives, securitization was already opaque enough without derivatives

John: regulators failed to regulate. Did not acknowledge what was going on around them. Regulation – just like compensation structures – failed to keep up with changes in financial system (risks, scale, markets)

Doug: agree there was a deregulatory posture. Doesn't think regulation was the problem. Thinks supervision – which flowed from the deregulatory posture – was important. Actual deregulation did not cause the crisis.

Brooksley: there was a posture. And think there was a reliance on self regulation. Led to significant erosion of regulation – includes supervision in that. Multiple layers. Failure to regulate new markets (like OTC derivatives, shadow banking markets), failures to oversee and supervise new kinds of institutions, inadequate regulation and supervision on hedge funds and others, pressure on supervisors not to enforce. All the supervisory agencies had failures. CSE is the poster child. Mortgage origination, securitization, derivatives, with respect to institutions. Financial system is critical for the economy and is prone to excess. We went too far in deregulating. Same euphoria affected regulators and policymakers. The supervisors failed.

Byron: interesting that same industry participants that would advocate for less regulation also got bailed out. And, interesting that in testimony some asked for more regulation.

How causal?

Bill: with enforcement, different products, different ratings—contributing. Not causal by itself.

Brooksley: one of the primary.

Phil: on scale on corporate risk management.

John: essential for housing bubble. That was seminal. HOEPA. Gaps in regulation maybe not causal. Poor supervision/implementation is causal. Failures of mortgage market supervision were essential for the crisis. And, downstream stuff too – should have been better supervised.

Bill: mortgage market not core mission for Fed. Should have used dormant tools? They never did it. Regulatory arbitrage would have worked around regulations if they had been implemented. Congress is responsible for allowing loop holes that would have allowed this arbitrage. Major contributor.

Phil: OCC and OTS had lots of authority. Failure of supervision. Existing substantial power that was not exercised. And, the system evolved and regulatory system didn't, creating gaps in the system. When you see gaps, suppose to point them out.

Bill: causes: excess money. (could have done different things with it. necessary, not sufficient.)

To do: add dismantling of appraisal regulations in mortgage regulation report