

Preventing The Next Crisis

Paul Willen

Federal Reserve Bank of Boston

NECAG Conference
November 9, 2010

I am speaking today as a researcher and a concerned citizen and not as a representative of the FRB Boston or the Federal Reserve System.

Brochure



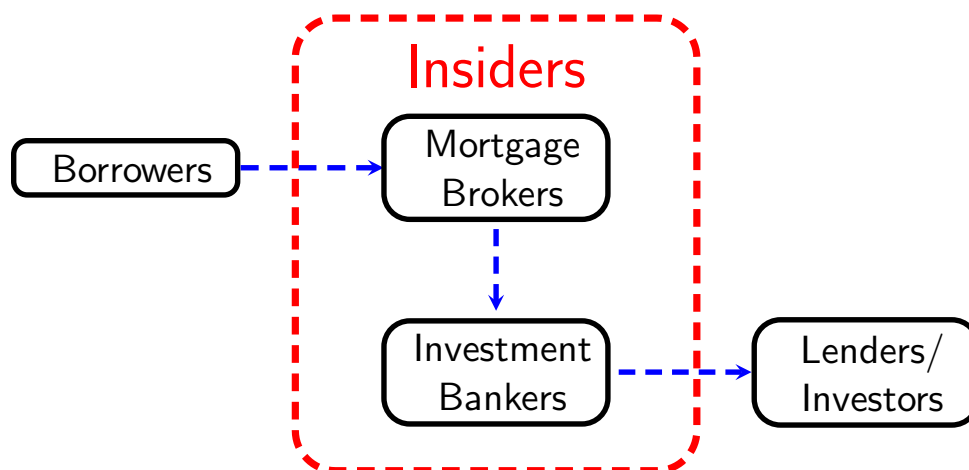
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of the Comptroller of the Currency
Office of Thrift Supervision



The question

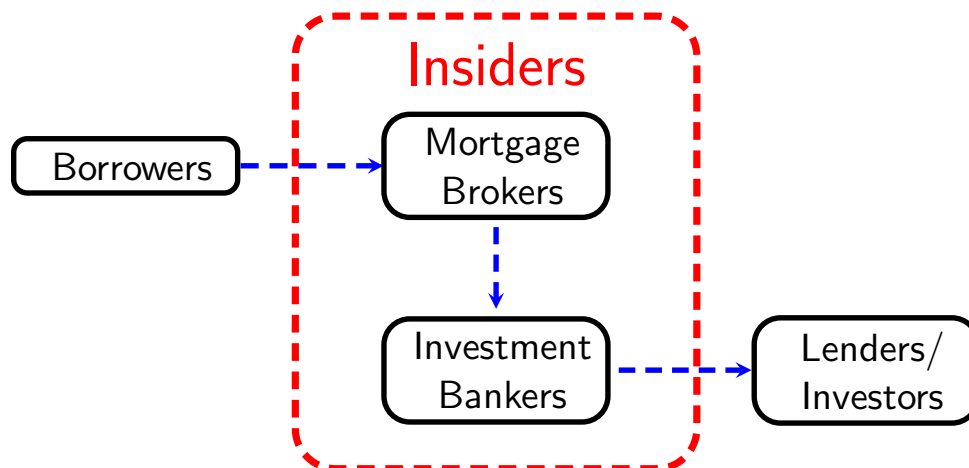
- Brochures not enough...
- The question:
 - Why did so many people make such bad decisions?
 - Why did borrowers take out loans they couldn't repay?
 - Why did the lenders lend them the money?

Why did so many people make bad decisions?



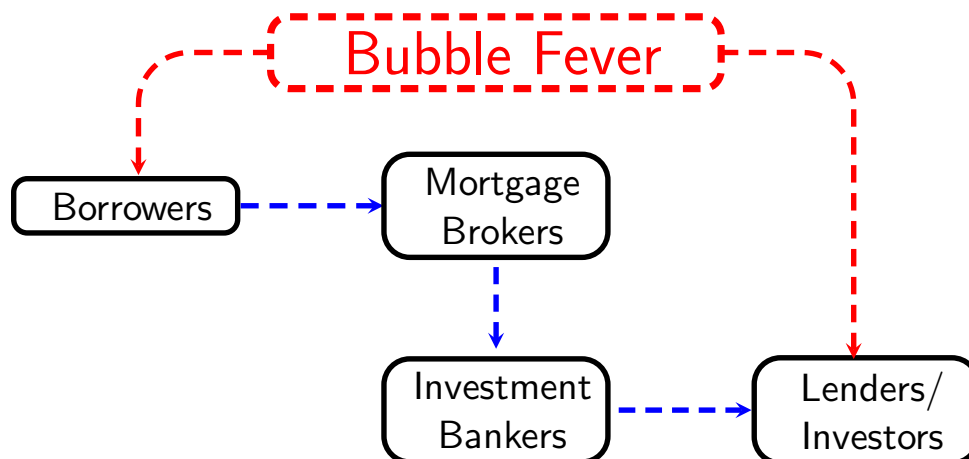
- Insiders have private information.
- Deceive investors and borrowers.
- Brokers push “exploding” mortgages.
- Bankers create “toxic” securities and hide problems.

Why did so many people make bad decisions?



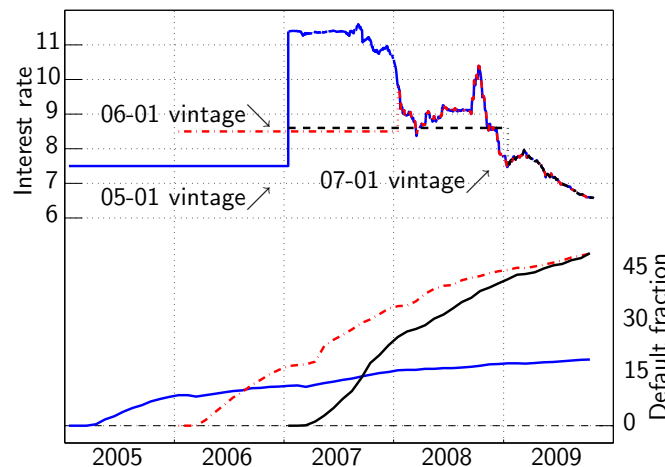
- Will show that most evidence contradicts story
- Exploding mortgages not a problem
- Banks did not hide what was going on.
- Investors could and did figure it out

Why did so many people make bad decisions?



- So what was the problem?
- Bubble Fever: Borrowers and lenders were trying to cash in on the biggest real estate boom in American history
- It is hard to stop consenting adults.

Exploding Mortgages



- Borrowers who got loans in 2005 faced big resets
- But there was no associated jump in defaults when they hit

A policy experiment

- At the end of 2006, the city of Chicago passed a law requiring counseling for at-risk borrowers – targeting subprime loans.
- Amromin et al. (2009) show that the program was quite effective:
 - Targeted lending types declined by 73%
 - Loans that were made performed much better.
 - Many foreclosures were prevented.
- Borrowers and would-be borrowers must have been very grateful...
 - Residents in the target areas passionately hated the program.
 - It was suspended after only 4 months.

Investors

- From the top:

*...by breaking the direct link between borrowers and lenders, securitization led to an erosion of lending standards, resulting in a market failure that fed the housing boom and deepened the housing bust.
(Geithner and Summers, 6/15/2009)*

- Pseudo-technical term: “Originate-to-Distribute” or OTD model.
- My view is that lenders basically understood what they were buying.
 - Link was broken long ago
 - Investors seem to have understood the risks.

Eager Investors: Lehman Brothers

- Brookings Papers on Economic Activity, Fall 2008: 69–145. Joint with Gerardi, Lehnert and Sherlund.
- Lehman Brothers: “U.S. ABS Weekly Outlook,” August 15, 2005.
- “HEL Bond Profile Across HPA Scenarios”

#	Name	Scenario	Loss	Probability
(1)	Aggressive	11% HPA over the life of the pool	1.4%	15%
(2)		8% HPA for life	3.2%	15%
(3)	Base	HPA slows to 5% by end-2005	5.6%	50%
(4)	Pessimistic	0% HPA for the next 3 years 5% thereafter	11.1%	15%
(5)	Meltdown	-5% for the next 3 years, 5% thereafter	17.1%	5%

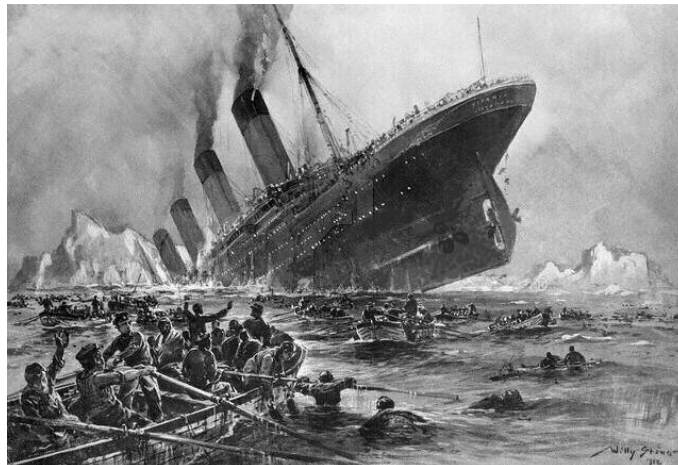
- Actual HPA: -10% annualized from Q4, 2005 to Q4, 2008
- Forecast losses as of 2/2009 in 2006-1 ABX from JPM: 23.44% (assuming -30% HPA in 2009!)

Bubbles and policy

- Bubbles are like earthquakes
 - We cannot predict when they will happen.
 - We cannot stop them once they've started.
 - Large movements in asset prices occur far more frequently than theory predicts.
- But that doesn't mean we can't protect people

"The 1989 earthquake near San Francisco in California was of similar magnitude to Haiti's but killed just 63 people, mainly because the buildings there are designed to withstand the shock." (The Economist Feb. 20, 2010.)
- "Structures" can withstand an economic earthquake.
 - Can this homeownership survive a 30% fall in house prices?
 - Can this bank survive a 30% fall in house prices?
- Well understood in 2005 that a big fall in prices would lead to massive defaults by subprime borrowers
 - An acceptable risk for a lender?

Disaster and policy



- Many people died because of shortage of lifeboats.
- Proposal: Steamship Company must disclose number of lifeboats.
- But the ship was "Unsinkable."
- Solution: Require ship to have enough lifeboats for everyone.

The slide you've all been waiting for...

- The end.