

PANEL I The Subprime Crisis: Origin and Implications

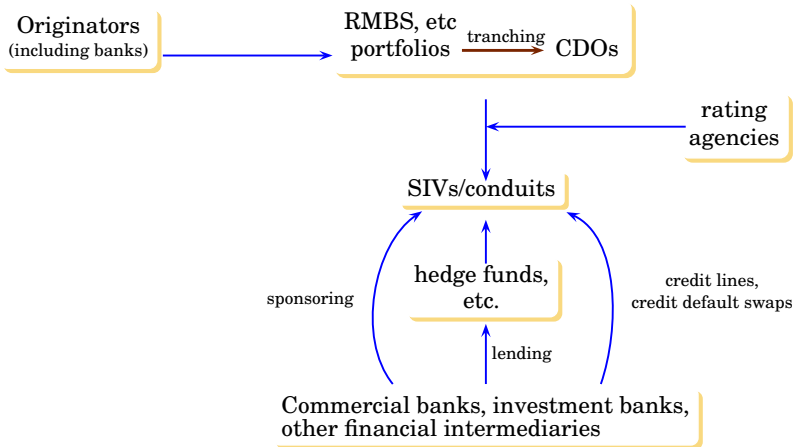
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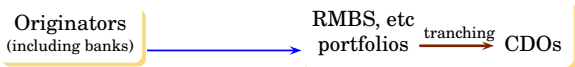
April 4, 2008



- ✓ No need to rehash well-documented sequence of events
- ✓ Textbook case for economics of information
 - MH (moral hazard)
 - AS (adverse selection)



Origination

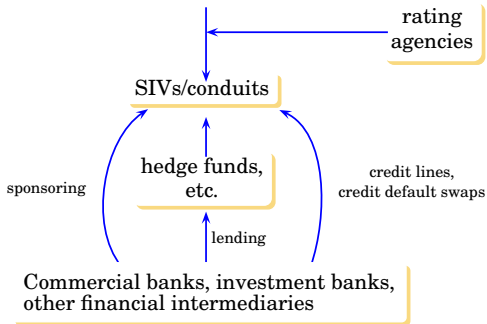


Theory:

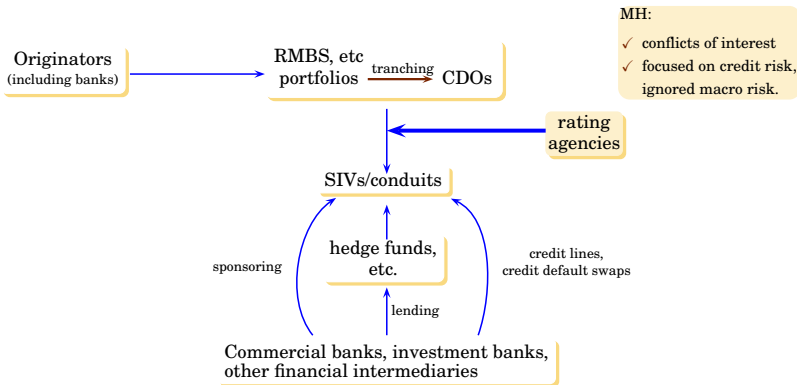
- should keep non-negligible fraction on balance sheet (and no use of derivative to undo position)
- should securitize riskier loans less

MH: securitize large fraction

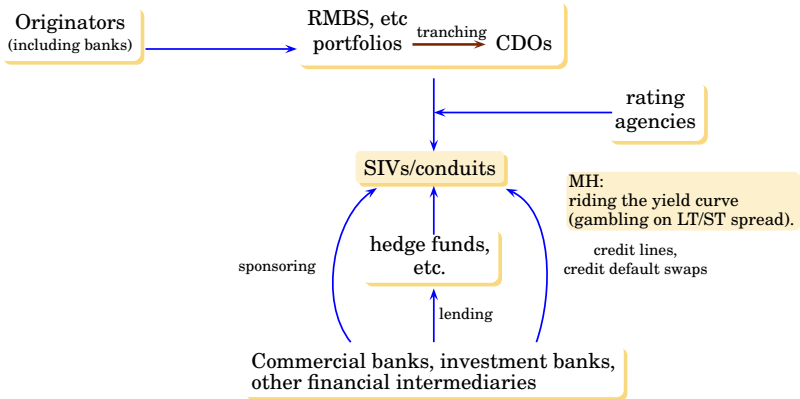
- large increase in securitization of riskiest mortgages (30% in 1995, 80% in 2006)
- evidence of MH: Keys-Mukherjee-Seru-Vig



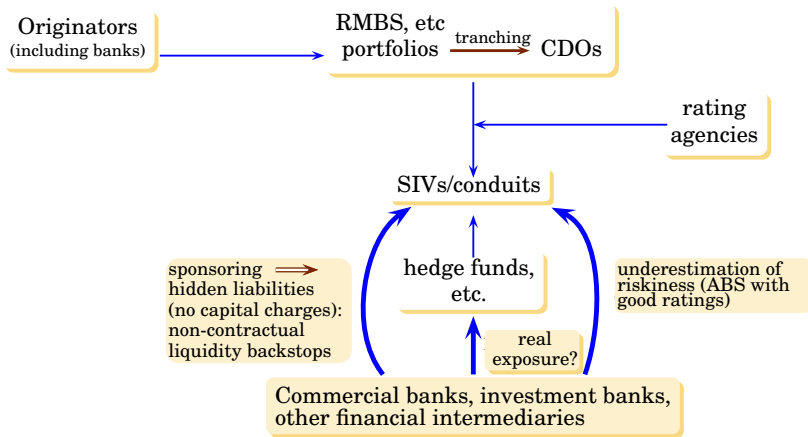
Certification by rating agency (badly needed: no market price. Mark-to-model)



Transformation by SIVs/conduits



Outmaneuvering capital charges



“Collective MH”

- “Strategic complementarities”: if financial institutions engage more in transformation, more constraints on monetary policy.
- Commercial banks, but also strong maturity transformation by investment banks, SIVs,...

As usual, MH becomes AS...

- direct exposure to losses? Web of obligations and indirect exposures?
- interbank market.

Liquidity is not only scarce, it is wasted.

Other standard ingredients

- amplification mechanism: fire sales (price softness)/margin calls (& mark-to-market),
- credit crunch (flight to quality): banks tighten standard across the board.

Despite this, a qualitatively new world ...

- Large increase in leverage of financial sector
[Adrian-Shin: leverage pro-cyclical]
- Disintermediation
- Exchanges vs OTC markets. No multilateral netting agreements
⇒ very opaque web of obligations.

✓ Raisons d'être

- (1) Representation function: stand for interest of depositors/taxpayers
[Dewatripont-Tirole 1994]
- (2) Systemic risk (Bear Stearns)

✓ Possible reforms

Rating agencies: limit conflicts of interest, require more transparency of methodology (especially if ratings are to be used in prudential assessments).

Financial institutions

✓ *Mark-to-market*

- rationale: discipline (ex ante choice of assets, avoidance of ex post gambling), prompt intervention
- costs: exposure to non-controllable market risk; less appealing when asset markets subject to substantial macro shocks

Cyclicalities of capital adequacy requirements

- currently none in principle (but non-indexed deposit insurance, Spain)
- theory (should be pro-cyclical) vs political economy...

- ✓ Better measurement of hidden liabilities (sponsored funds, investment in SIVs, etc...)
- ✓ New ingredient: investment banks can be bailed out
[wipe out shareholders, fire management, and temporarily nationalize bank?]
- ✓ Gambling on macroeconomic shocks: large but infrequent losses.

- ✓ Has been conventional: lower ST rates (key to refinancing), liberal collateral regime. Not targeted (while brunt of losses borne by financial sector).
- ✓ Another form of bailout; hard to avoid ex post, but invites next crisis.