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The Subprime Turmoil: What's Old, What's New, and What's Next

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Discussion of "The Subprime Turmoil: What's Old, What's New, and What's Next"

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Disclaimer: The views in this presentation are those of the author and should not be attributed to the International Monetary Fund

General comment

- One of the best accounts of the origins and consequences of the crisis, and early lessons going forward
- This is not a paper but a book!

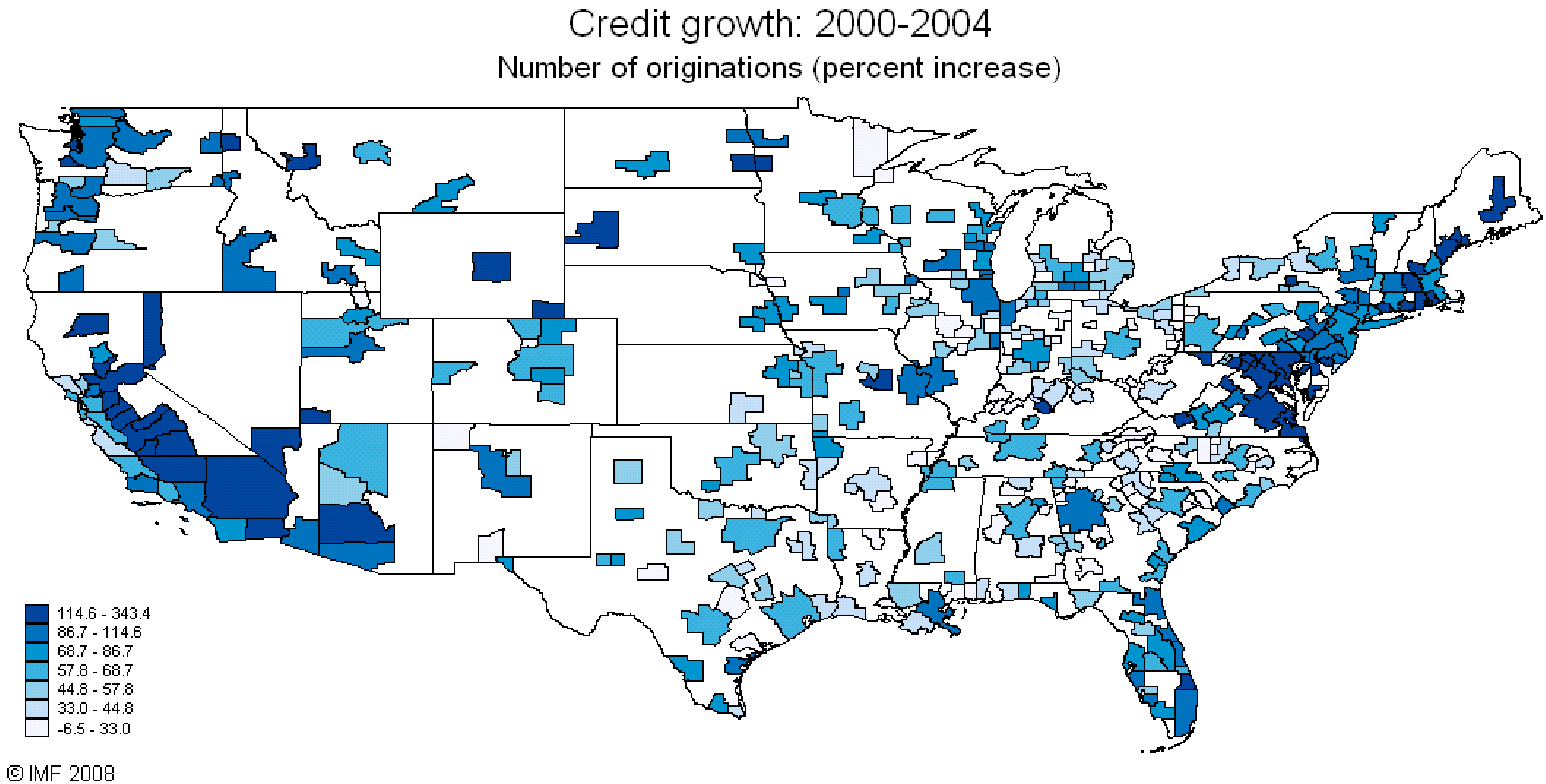
What's Old?
Unfortunately, too much!

- Massive government intervention
- Ad hoc measures
- Excessive liquidity support
- Regulatory forbearance
- Blanket guarantees
- Bailouts that transfer wealth from creditors to debtors
- Moral hazard going forward
- Risk of overregulation

House prices

- Peak-to-through decline in house prices of 5% seems rather optimistic, given number of mortgages in negative equity and/or in arrears
- Externalities – neighborhood effects of foreclosures
- Housing is a localized market; house price declines will be significantly larger in some areas and local impact on real economy could be pronounced
- Welfare implications: Increased home ownership has social value

Where was the mortgage boom?



Credit boom gone bad

Prudential regulation

- Bank regulation needs to become incentive compatible
- Extend prudential regulation to all systemically-relevant financial institutions
- Need to strengthen capital and liquidity requirements
- Increase systemic resilience to shocks by using countercyclical prudential policies and eliminating incentives that encourage leverage
- Development of stronger frameworks for the resolution of (cross-border) financial institutions
- Ensure consistency of policies across jurisdictions and financial institutions to avoid regulatory arbitrage

Regulation going forward: contain moral hazard

- Agree that the increased expectation of government protection (moral hazard) is a major problem going forward
- Many financial systems have reached a size where their rescue may be beyond the financing capacity of the sovereign
- How to return to a financial system without large role for government (blanket guarantees and government ownership)?

Regulation going forward: do not stymie innovation

- It is at times like these that the worst regulations are put in place
- In the reform process, the new architecture needs to take into account the inherent limitations of regulation and supervision
- Regulation tends to lag behind financial innovation
- Also, the costs of regulation for the users of regulated financial services need to be borne in mind, as well as the benefits of competition and financial innovation
- Financial sector consolidation has potentially negative consequences for both

Not all capital is alike

- Banks have raised large amount of equity from the market
- Liability and capital structures have consequences for market discipline
- Relation between bank regulation & risk depends on each bank's ownership and governance structure
- For example, owner controlled banks exhibit higher risk taking behavior than banks controlled by managers
- Basel II (III?) and national regulations need to consider bank ownership and governance, and owner/manager incentives

Subordinated debt proposal

- May not be a viable option in many countries
- Problematic if informed debtholders run first and there are uninformed but (partly) uninsured depositors and other debtholders
- How to enhance market discipline in the context of generous protection and implicit guarantees

Credit ratings

- Agree that regulatory use of ratings may have contributed to ratings grade inflation, but:
- Regulatory use of ratings may be necessary in environments where it is costly to acquire information
- May be ratings need to be paid by investors rather than issuers

Monetary policy

- You argue that loose monetary policy contributed to the subprime crisis
- May be, but even if so, not clear whether monetary policy should be altered to deal with asset bubbles
- Even if certain types of asset bubbles are worth intervening, the question is whether this is a task for monetary policy
- Countercyclical administrative and prudential measures may be more effective tools to safeguard financial stability in light of bursting asset bubbles