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

Luc Laeven
International Monetary Fund and CEPR

Presented at the 9th Jacques Polak Annual Research Conference
Hosted by the International Monetary Fund
Washington, DC—November 13-14, 2008

The views expressed in this paper are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the paper.
Discussion of
“The Subprime Turmoil: What’s Old, What’s New, and What’s Next”

Luc Laeven
(International Monetary Fund and CEPR)

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 growth: 2000-2004
Number of originations (percent increase)
Credit boom gone bad

![Graph showing the relationship between Growth of Loan Origination Volume 2000-2004 and Change in Delinquency Rate 2004-2006 (in percent).]
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