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THE CREDIT CRISIS—WHAT WENT WRONG?

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Background

Credit crises are not new threats to the global economy. Many countries have defaulted, nearly defaulted, or repudiated large amounts of sovereign debt over the past century. In recent decades, Latin and South American countries in particular as well as Russia have roiled financial markets on a number of occasions. But the credit crisis that is currently sweeping through global financial markets is fundamentally different in at least five critical ways, qualifying it as one of the most significant threats to the global economy in the post-Depression era:

- The crisis originated not in small or underdeveloped economies fraught with political risk but in large, well established and sophisticated financial markets, primarily the United States;

- The crisis was created and exacerbated by some of the largest, most sophisticated financial institutions in the world, suggesting a collapse of basic risk management with catastrophic financial consequences;

- The crisis was triggered, transmitted and fueled not by widespread defaults on debt instruments as in past credit crises but through excessive leverage (borrowing) and widespread securitization of complex structured financial products by some financial institutions. The leverage amplified even small changes in real (or perceived) risk associated with the underlying debt instruments which were then transmitted globally via securitization, resulting in a rapidly spreading and, at times, largely uncontained risk;

- Regulatory and accounting mechanisms for identifying, monitoring, quantifying and controlling excessive exposure to credit risk were at best ineffective and at worst outright failures, raising fundamental questions regarding the current nature and form of regulation, its adequacy as well as necessary proscriptive changes to prevent such collapses in the future. Liquidity concerns also loomed large.

- Traditional economic policy tools (such as central bank interest rate reductions and fiscal stimulus initiatives) were not designed to manage credit and liquidity crises and are therefore are of limited effectiveness.

History and Origin of the Credit Crisis

Viewed simplistically, the current crisis in global financial markets is merely the manifestation of the collapse of two intertwined bubbles—credit and housing. Lending to poor quality (i.e., subprime) credit risks to finance home purchases had been stretched further and faster than any other segment of the credit markets, facilitated by a steady but rapid progression toward increasingly lax lending standards—with wholly predictable consequences. Subprime mortgage

lending was merely the weakest point of the credit bubble and was therefore the first credit segment to burst.

The bursting of any financial bubble by definition implies rapid and significant asset price deflation. This is clearly the case for homes in the United States today, the price of which has dropped 10 to 20 percent in many markets. Similar problems on a smaller scale exist in the United Kingdom, as the collapse and subsequent nationalization of Northern Rock in February 2008 dramatically illustrated.

Viewed dispassionately, the collapse of the U.S. housing bubble is deserving of little historical distinction. Home prices were far outside historical norms relative to income and supply vastly exceeded demand. Economic history is littered with the wreckage from the collapse of countless asset bubbles—from the "tulipmania" that gripped Holland in the 17th-century to inflated share prices in Silicon Valley internet companies (dot-coms) during the early years of the current century. Indeed, commodities prices today are almost certainly in the midst of a bubble, led by the price of oil.

Yet homes—the most valuable asset owned by the average American—are not ordinary assets. This fact has important consequences for the public policy responses discussed in subsequent sections of this paper. Real estate bubbles in particular are not new, of course. Japan suffered through the "lost decade" of the 1990s following the collapse of its real estate bubble in the late 1980s. But that crisis was largely contained within Japan itself (and the Japanese banking sector in particular).

The (Nearly) Uncontained Nature of the Current Credit Crisis

One of the most important distinguishing features of the current credit crisis is its nearly uncontained nature. Unlike the Japanese real estate crisis, the collapse of the US credit bubble was not ultimately confined to real estate nor was it confined to the United States economy or even its large financial institutions. Indeed the effects were both international in scale and nearly instantaneous. As tainted subprime debt (or securities linked to that debt) turned up on the balance sheets of financial institutions large and small around the world, lending even in well established global credit markets (such as overnight interbank loans) began to dry up. Interest rate spreads around the world rose dramatically. Even in markets where default risk had not increased, such as the market for US municipal bonds, appetite for such low risk debt shriveled as bond insurers' guarantees on unrelated subprime securities threatened the insurers' solvency. Concern evolved into fear and ultimately panic as increasingly large numbers of individual and institutional investors sought simultaneously to reduce or eliminate exposure to many (if not all) categories of debt irrespective of default risk. Mass liquidations of positions therefore contributed to an ancillary liquidity crisis—sellers were plentiful but buyers were few—causing markets to seize. Banks no longer trusted one another even for the shortest of loans.

Availability problems quickly developed in many other credit market segments apart from real estate, including ordinary corporate debt, commercial paper, credit cards, student loans and auction rate securities. As credit dried up and fear of defaults (real or perceived) spread, secondary markets began to seize for want of bidders while auctions for new issuances failed on a number of occasions for the same reason. The cost of buying "insurance" against defaults pushed the cost of credit default swaps up exponentially.

The ability to efficiently achieve diversification of financial risks (in this case credit or default risk) on a global scale is generally viewed as of the most important and positive financial market achievements of the past 30 years. Yet the current economic crisis provided a vivid demonstration that contagion effects remain a concern and that the theory of economic "decoupling" is exceptionally naïve.

In the wake of the global credit crisis, public policymakers (including financial institution regulators and central banks) must address the following key questions:

- How can the early warning signs of future financial crises be more readily identified and acted upon sooner?
- Where are the critical gaps in the international regulatory and accounting architecture that today serve as the final line of defense against imprudent risk taking?
- Can these gaps be closed (or significantly narrowed) without the creation of excessively onerous new regulations that serve only to diminish the benefits that financial engineering brings or stifle the creation of new products?
- How should complex securities be rated in a way that provides useful information to investors about risk?
- Are "mark-to-market" requirements more harmful than helpful in providing a true picture of the economic health and viability of a company? Could fair value accounting requirements such as market-to-market someday spark a shortage of capacity within the insurance industry?
- Why types of policy responses are optimal for credit and liquidity crises arising in developed economies?

Requiring enhanced risk management controls and liquidity are obvious starting points, but such requirements were in place pre-crisis and could be circumvented. Any solution is complicated by the fact that different regulatory and accounting schemes were in place in the United States and Europe at the time the crisis emerged (a difference that remains in place today), suggesting shortcomings that transcend regulatory philosophies and accounting requirements.

The Credit Crisis and the Failure of Risk Management

In the final analysis regulators cannot and should not be held to blame for the current credit crisis. Put bluntly, the blame lays squarely at the feet of those financial institutions whose basic risk management controls were proven inadequate or were effectively or deliberately ignored. Reports have emerged that individual risk managers who spoke out against the accumulation of dangerously high (but profitable) levels of credit exposure were in some instances terminated or reassigned. Clearly, one dimension of the review of risk controls must involve an examination of incentives for management to ignore or override those controls.

The Form and Nature of Regulation

As the credit crisis spread across the globe it exposed numerous shortcomings and weaknesses in the various regulatory schemes in operation. Specifically, the enormity of the risks accumulating on the balance sheets of many financial institutions was not identified by regulators operating under supervisory and accounting rules in the United States or Europe. It is also clear that contagion effects and systemic risk were hallmarks of the current crisis. The question is why and what can be done to limit systemic risk.

Another fundamental question that arises is whether regulation of financial institutions should be "rules based" as is currently the case in the United States or "principles-based." How much trust can or should regulatory authorities place in large financial institutions? Excessive or inappropriate regulation could increase costs, stifle innovation and still fail to head-off the next

crisis. It is also likely that regulatory reforms will be primarily targeted toward banks with potential spillover effects for insurers.

Finally, it is clear that policymakers in the United States did not have policy tools at their disposal that were appropriate for countering the current financial crisis. Cutting key interest rates or legislatively approved economic stimulus packages did little to lubricate away the fear that has caused so many credit markets to seize. Repeated cuts by the United States Federal Reserve and a $168 billion economic stimulus package could not prevent what amounted to near runs on some financial institutions and the collapse of Bear Stearns. Central bankers and monetary officials have been forced to improvise and make major policy decisions reactively as events unfold. In the United State, the Federal Reserve's willingness to take the unprecedented step of swapping subprime tainted debt for risk-free Treasury securities has been the single greatest confidence booster for credit markets (though taxpayers have been put at some considerable risk).

It is worth noting that the Federal Reserve's rate cutting campaign, while generally ineffectual at stemming or limiting credit or liquidity crises, is largely responsible for the collapse of the dollar. Because most commodities are traded in dollars, the price of oil, metals, grains and most other commodities have risen dramatically since mid-2007, raising the specter of inflation. The law of unintended consequences looms large in the current crisis. It is extraordinary to consider that events as seemingly disparate as recent food riots in Asia and oil worker strikes in Scotland are all linked to the collapse of the subprime mortgage meltdown in the United States.

Summary

The credit crisis that began in mid-2007 has roiled global economies for nearly a full year. A multitude of weaknesses in risk management, regulation, accounting and policy response have been revealed. The passage of time and further analysis will no doubt bring to light many additional areas of concern. All will need attention and global financial authorities seem determined to work in a concerted manner to reduce the likelihood of such events occurring in the future.