For Fox News, October 1, 2008

Subprime Mortgage Mess
Mortgages

Homeowner

(~ $250,000)

“lending”

Originator

Hold it

Sell it
Mortgage Backed Securities

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Institutional investor buys and holds

Investment bank pools it into a derivative

MBS

("securitization"

(~ $100 million)
Collateralized Mortgage Obligations, etc.

Institutional investor buys and holds safer parts

~ $2 billion

CMO

Investment banks hold riskier parts

“pooling”
Broken Up Into “Tranches”

CMO

“repackaging”

AAA (low risk/low return)
AA
A
B (higher risk/higher return)
BBB
BBB -

Unexpectedly high default rates ~ 25% so prices plummet

“Credit enhanced” but credit insurance fails
## Investment Bank’s Balance Sheet

### Then

<table>
<thead>
<tr>
<th>Assets (things owned)</th>
<th>Liabilities (things owed)</th>
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<tbody>
<tr>
<td>Cash $1 billion</td>
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NET WORTH (A-L) = $0

*Short term creditors stop lending
*Rating agencies downgrade so the IB can’t sell more long term debt
*Regulators step in to ensure the IB does not become a “zombie”
## The Big Ripple Effect: Systemic Uncertainty

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*Short and long term creditors stop lending
*Bank must suspend new business
*Economy begins to suffer:
  - real GDP declines
  - increased unemployment
  - more mortgage defaults …
Why Are Default Rates So High?

The "Bubble"

U.S. Home Price Index

1990 2002 2006

Time
Why Are Default Rates So High?

Poor underwriting practices:

- Mortgage originators were paid a commission upfront so they had an incentive to sign up literally anybody
- Competition for business leads to “a race to the bottom” in terms of credit standards

RESULT =

- NINJA loans
- 125% of equity
- ARMs, etc.
Partisan Democrats say markets stink
Partisan Republicans claim regulators reek

Statesmen and scholars know that both are right (wrong)

Hybrid failure = both market and government failures needed to create this stench
Market Imperfections

1. The home price bubble
   - People paid too much with the expectation that they could always “flip” for a profit
2. Asymmetric information
   - Unclear which institutions are solvent and which are not so credit markets are frozen
3. Uncertainty
   - Nobody knows what the future will bring so there are wild swings in stock prices, spreads, and so forth
Government Failures

1. Various policies promoting high home ownership rates
   - Low interest rates; mortgage interest deduction; market meddling via Freddie, Fannie

2. Too Big To Fail Policy
   - Encouraged financial institutions to grow larger instead of stronger/safer

3. Regulators’ neglect of history
   - The 6 mortgage securitization schemes that blew up between the Civil War and W.W. II were forgotten.
   - Also ignored was the fact that the insurance industry and regulators worked together to fix a similar incentive problem.