

ABA “FEATURED SPEAKER” ADDRESS

Section on Business Law Annual Leadership Meeting, Scottsdale, AZ,
January 17, 2009

Perspectives on the Subprime Financial Crisis¹

By **Steven L. Schwarcz**²

I. HOW AND WHY DID THE FINANCIAL CRISIS HAPPEN?

The financial crisis resulted from a systemic cascade of failures, initially triggered by the historically unanticipated depth of the fall in housing prices. Loans to risky borrowers were often made with the expectation of refinancing through home appreciation. When home prices stopped appreciating, these borrowers could not refinance. In many cases, they defaulted.

These “subprime” loan defaults in turn caused substantial amounts of low-investment-grade-rated mortgage-backed securities to default and AAA-rated securities to be downgraded. The defaults were especially large for

¹ © 2009 by Steven L. Schwarcz. **These remarks are based in part on the author’s forthcoming article, *Understanding the ‘Subprime’ Financial Crisis*, forthcoming 60 S. C. L. REV. (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1288687.**

² Stanley A. Star Professor of Law & Business, Duke University School of Law; Founding/Co-Academic Director, Duke Global Capital Markets Center.

ABS CDO securities—a class of securities backed indirectly by subprime mortgages and other assets—because of the leveraged sensitivity of these securities to underlying mortgage defaults.

That, in turn, spooked investors who believed that “AAA” meant iron-clad safety and that “investment grade” meant relative freedom from default. Investors started losing confidence in ratings and avoiding debt securities. Fewer investors meant that the price of debt securities started falling. Falling prices meant that firms using debt securities as collateral had to mark them to market and put up cash, requiring the sale of more securities, which caused market prices to plummet further downward in a death spiral.

This death spiral appears to have been made worse by the high leverage of many firms. Encouraged by the earlier liquidity glut, many firms had borrowed excessively because the cost of funds was so cheap.

The refusal in mid-September 2008 of the government to save Lehman Brothers, and its resulting bankruptcy, added to this cascade. Debt markets became so spooked that even the commercial paper market virtually shut down. And the market prices of mortgage-backed securities collapsed substantially below the intrinsic value—essentially the present value of the expected value of the underlying cash flows³—of the mortgage assets underlying those securities.

³ This amount could be estimated, as was done in a High Court of Justice case involving the Orion Funding SIV in which I served as an expert witness, by examining the mortgage loans underlying the securities and ascertaining which were subprime, which were prime, and which were delinquent or in default.

This collapse in market prices meant that banks and other financial institutions holding mortgage-backed securities had to write down their value. That caused these institutions to appear more financially risky, in turn triggering concern over counterparty risk: afraid these institutions might default on their contractual obligations, many parties stopped dealing with them.

In October 2008, the federal government stepped in to the rescue with the Emergency Economic Stabilization Act (sometimes called the “TARP” for its initial emphasis on its Troubled Assets Relief Program). But government actions until September were spearheaded by the Federal Reserve, which focused almost exclusively on protecting banks and other financial institutions against collapse. This narrow focus reflected the Fed’s historical and legal mission, memorialized in its organizing laws (section 13(3) of the Federal Reserve Act) which enable it, in “unusual and exigent circumstances,” to act as a lender of last resort to banks and other financial institutions.

Such a narrow focus worked well when banks and institutions were the primary source of corporate financing. But as the current financial crisis reveals, this focus is insufficient now that companies obtain much of their financing directly through capital markets (“disintermediation”).

Although there is currently great attention paid to the need for governments to bail out banks and other financial institutions, these institutions would not have needed to be bailed out if their investment

securities had maintained market value reasonably corresponding to their intrinsic value.

II. HOW REALISTIC IS THE TARP?

Under the original plan, counterparty risk would be minimized primarily by the government purchasing mortgage-backed securities from banks and other financial institutions at a price above the collapsed “market” price but, hopefully, at a deep discount from what the securities are intrinsically worth. This would effectively recapitalize these institutions with more transparently valuable assets (cash).

This approach ran into immediate political hurdles based on misunderstanding the distinction between market price and intrinsic value. Because the purchase price paid by the government would have to be above “market” to avoid even further counterparty write-offs, there was a populist perception that the government would be unjustifiably bailing out Wall Street.

In response, the government has attempted to recapitalize banks and other financial institutions primarily by purchasing preferred, non-voting stock. To date, however, this approach has not been entirely successful. Among other problems, recapitalized banks have been highly reticent to make new loans.

I believe that the original approach, buying mortgage-backed securities, or “MBS,” was preferable. If the market price of the MBS was, as

I believe and the IMF has now confirmed, much lower than the intrinsic value of the securities, the government, and therefore taxpayers, would profit.

Buying MBS has its own issues, of course. It's hard to price absent transparency of the condition of the underlying assets (e.g., mortgage loans) and their obligors. Part of the very reason that the market has failed is that disclosure of some of the MBS has become so complex that investors are simply uncertain how much these securities are worth. In that case, however, the same flexible pricing approach that is used in structured financing transactions to buy financial assets of uncertain value should work in this context, including the accounting considerations. Buying MBS also would have at least bracketed the range in which these securities should be priced.

III. WHAT SHOULD BE DONE TO AVOID FUTURE FINANCIAL CRISES?

It is impossible to know how future financial crises will arise. Ultimately, the key to protecting against them is to remain open, flexible, and aware of changing circumstances. To this end, government should take a broad and flexible approach. I have mentioned how the Federal Reserve initially focused almost entirely on its narrow legal mandate to protect institutions, not markets.

It may well be helpful to have a central governmental agency with a mandate to protect against financial crises of any type, including financial market stability. In the United Kingdom, for example, the Financial Services

Administration (FSA) is the single organization responsible for all financial institutions and markets, and several other countries have their own governmental equivalents of the FSA. Fully centralizing government responsibility in a single agency might, however, itself create an unintended degree of tunnel vision. It also might impede the insights that come with regulatory competition. It might be better to have separate agencies with merely something like a centralized coordinating committee.

To protect against future crises, we also should try to learn from the nature of the fundamental failures causing the subprime financial crisis. I have argued that most of the causes of the crisis can be divided conceptually into three categories: conflicts, complacency, and complexity. These categories are broad, but they do not capture everything. One might propose, for example, a fourth category: cupidity. Greed, however, is so ingrained in human nature and so intertwined with the other categories that it adds little insight to view it as a separate category. Government cannot meaningfully legislate against greed.

These categories also do not capture the full problem of systemic risk, whose uniqueness arises from a type of tragedy of the commons. Because the benefits of exploiting finite capital resources accrue to individual market participants whereas the costs of exploitation, which affect the real economy, are distributed among an even wider class of persons, market participants have insufficient incentive to internalize their externalities.

I will address this more theoretical nature of the problem of systemic risk after addressing the fundamental categories of conflicts, complacency,

and complexity which themselves can lead, as in the current financial crisis, to systemic collapse. These categories embody market failures that firms should have protected against in their own self interest. The interesting question is why firms failed to do so.

The first category, conflicts, is the most tractable because, once identified, conflicts can often be managed. For example, concerns about moral hazard resulting from the originate-to-distribute model can be managed by better aligning the interests of originators (e.g., mortgage lenders) and investors, such as by requiring the former to retain a risk of loss. And conflicts in the way that managers are paid—receiving high compensations and bonuses for arranging deals or investments that later fail—can be managed by firms taking a more long-term view to compensation. This should be done not only for top managers but also for secondary managers, who make many important decisions regarding investments.

Complacency is a more difficult category because government cannot change human nature (although it can try to affect behavior). During a financial crisis, everyone becomes focused. But once the crisis recedes in memory and investors are again making money, the experience is that investors will always “go for the gold.”

Complexity is the most difficult category. It is increasingly a metaphor for the modern financial system and its potential for failure. Solving problems of financial complexity may well be the ultimate twenty-first century market goal.

Complexity comes in at least two forms. First, there is cognizant complexity: things are just too complex to understand. This manifests itself, for example, in the difficulty of achieving transparent disclosure for complicated investment securities, and also in the difficulty market participants have in learning the financial condition of their counterparties (due, for example, to counterparties selling credit-default-swap protection to third parties). Investors can at least partly address cognizant complexity by demanding more and better disclosure, including of contingent liabilities.

The second problem of complexity is temporal: in a complex system, signals are sometimes inadvertently transmitted too quickly to control. This manifests itself, for example, in the “tight coupling” that causes markets to move rapidly into a crisis mode. To address temporal complexity, we need to loosen this tight coupling. I have argued that this can be done by a governmental entity acting as the equivalent of a market liquidity provider of last resort, to help stabilize irrationally panicked markets by purchasing securities.

This type of targeted market investment should generate relatively minimal costs, and certainly lower costs than those of a lender of last resort to financial institutions—the Fed’s traditional role. By providing a lifeline to financial institutions, a lender of last resort fosters “moral hazard” by encouraging these entities—especially those that believe they are “too big to fail”—to be fiscally reckless. Loans made to these institutions also will not be repaid if they eventually fail. In contrast, buying securities at a deep

discount will mitigate moral hazard and also make it likely that the market liquidity provider will be repaid.

Such a market liquidity provider is needed because, in a panicked market, private investors may not act rationally—as we have seen in the current crisis. Also, private investors usually want to buy and sell securities, not waiting for their maturities, which discourages investing in times of falling prices and market uncertainty. A governmental market liquidity provider should be able to wait, if necessary, until maturity of the securities to profit.

Next consider the more theoretical nature of the problem of systemic risk. Because the benefits of exploiting finite capital resources accrue to individual market participants whereas the costs of exploitation are distributed among an even wider class of persons, market participants may not want to protect against these costs. Conceptually, therefore, the solution to systemic risk is to impose regulation requiring market participants to internalize these costs. Regulation to achieve that cannot be fully successful, however, because of the myriad ways in which the costs can arise.

But there still may be a pragmatic way to mitigate the likelihood of systemic collapse. Systemic collapses result from a chain of defaults; but if the chain can be broken, the defaults won't be transmitted. A market liquidity provider of last resort, of the type already mentioned, can break the chain of defaults by stabilizing irrationally panicked markets.

Consider how such a market liquidity provider of last resort could have helped to avoid, or at least mitigate, the subprime financial crisis. Once it recognized that panic was causing the market prices of mortgage-backed securities to fall materially below the level of their intrinsic value, the market liquidity provider could have stepped in to purchase sufficient quantities of those securities to stabilize the MBS markets. For example, if the intrinsic price was, say, 80 cents on the dollar and the market price had fallen to, say, 50 cents on the dollar, the market liquidity provider could purchase these securities at, say, 70 cents on the dollar, thereby stabilizing the market and still making a profit.

The U.S. Treasury Department's Fall 2008 purchases of mortgage-backed securities issued by Fannie Mae and Freddie Mac illustrated this potential, driving down 30-year fixed mortgage rates a full percentage point and creating a refinancing boom.

In the broader subprime crisis, however, by ignoring the collapse of the debt markets for so long, we may already have gone beyond a tipping point in the ability of market purchases alone to correct the problem. This is because the market-price collapses have virtually shut down the credit markets, which is harming the real economy because firms need credit to operate and grow. Even worse, in a feedback loop, the crashing real economy makes it more likely that obligors on assets underlying the debt securities will default. Increasing defaults further lower market prices, thereby further reducing credit availability, which further harms the real economy. Our job now is to regain confidence to escape this feedback loop.