

For Fox News, October 1, 2008

Subprime Mortgage Mess

Mortgages

Homeowner



(~ \$250,000)



“lending”

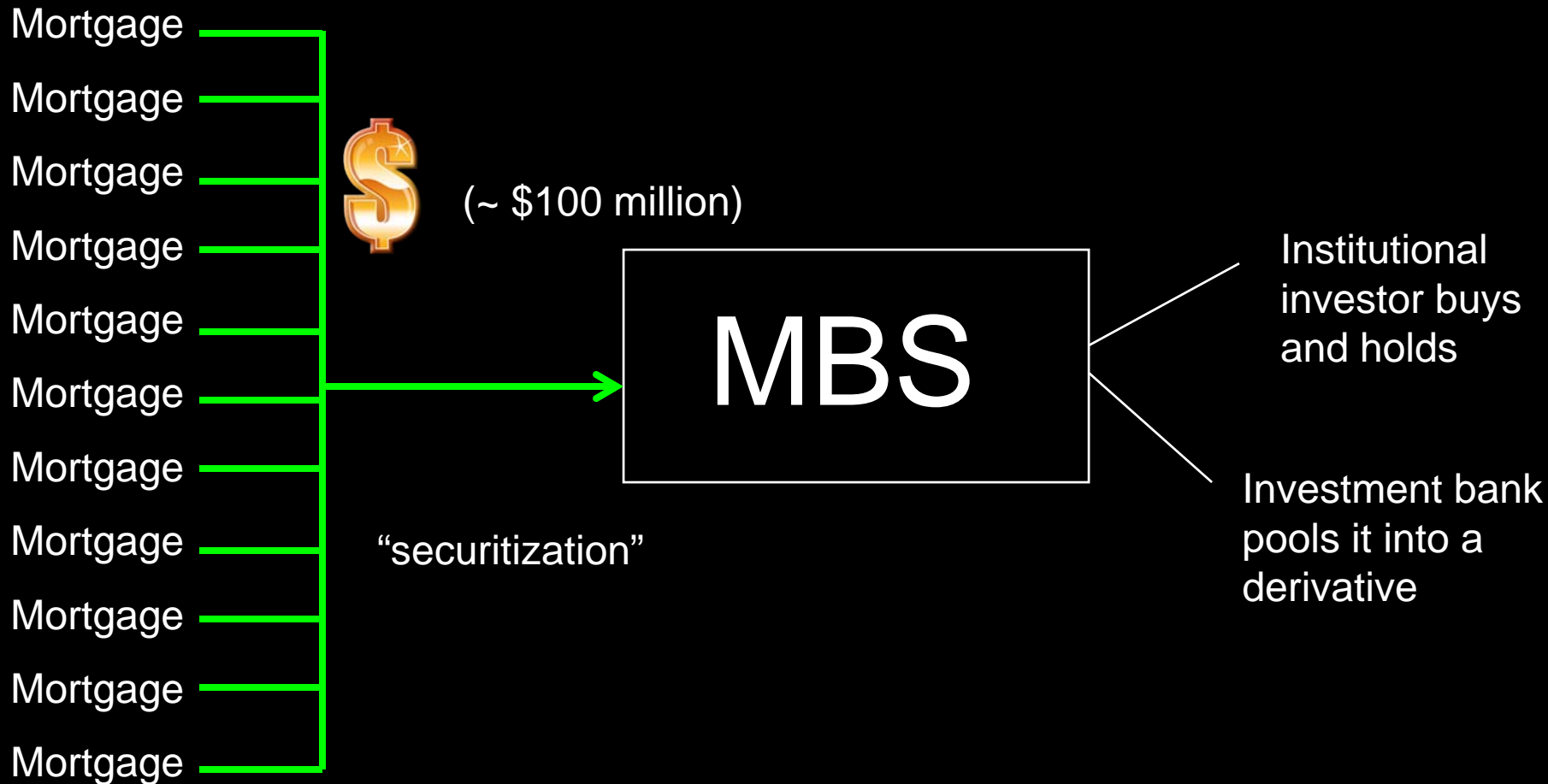
Originator



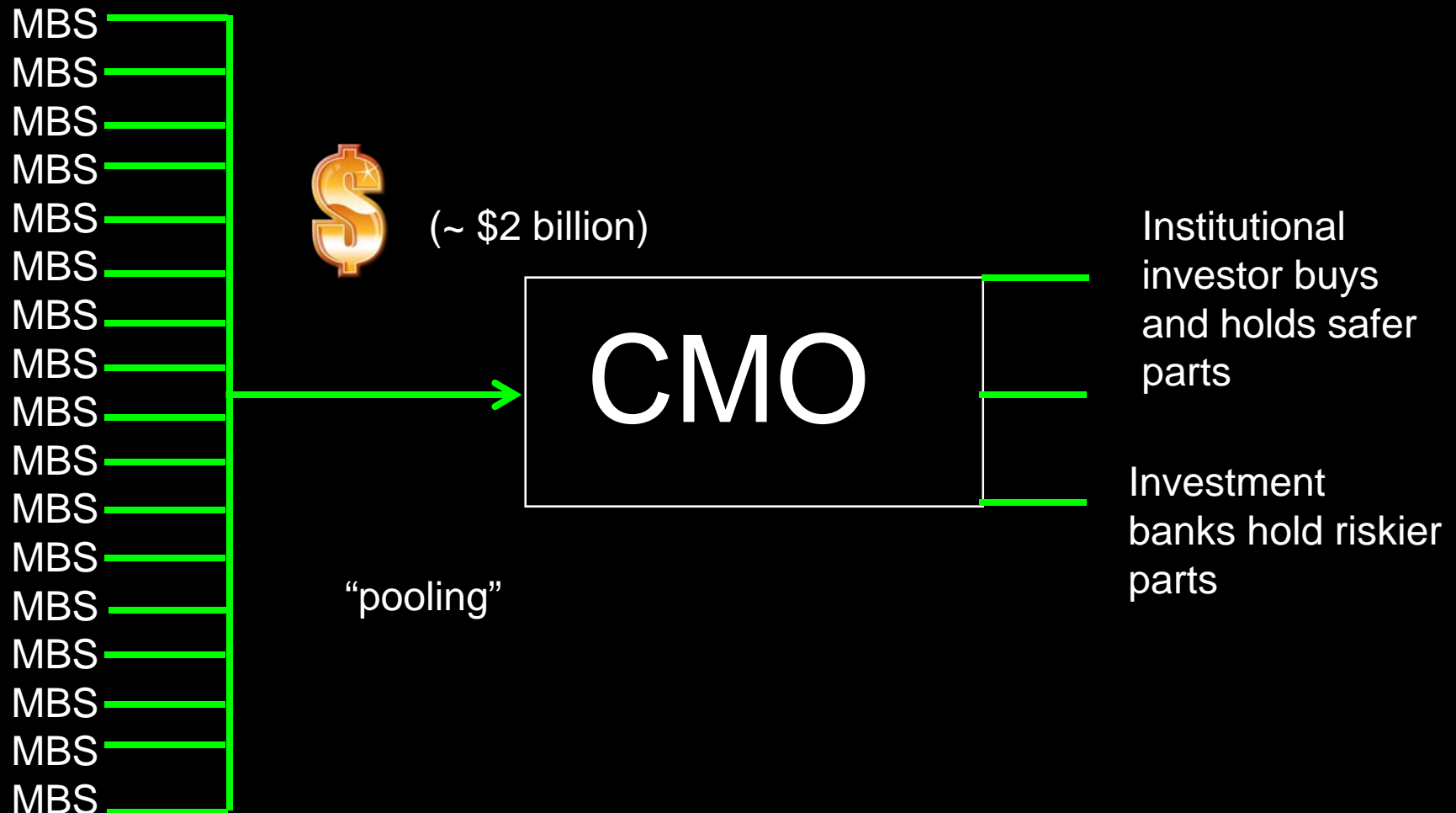
Hold it

Sell it

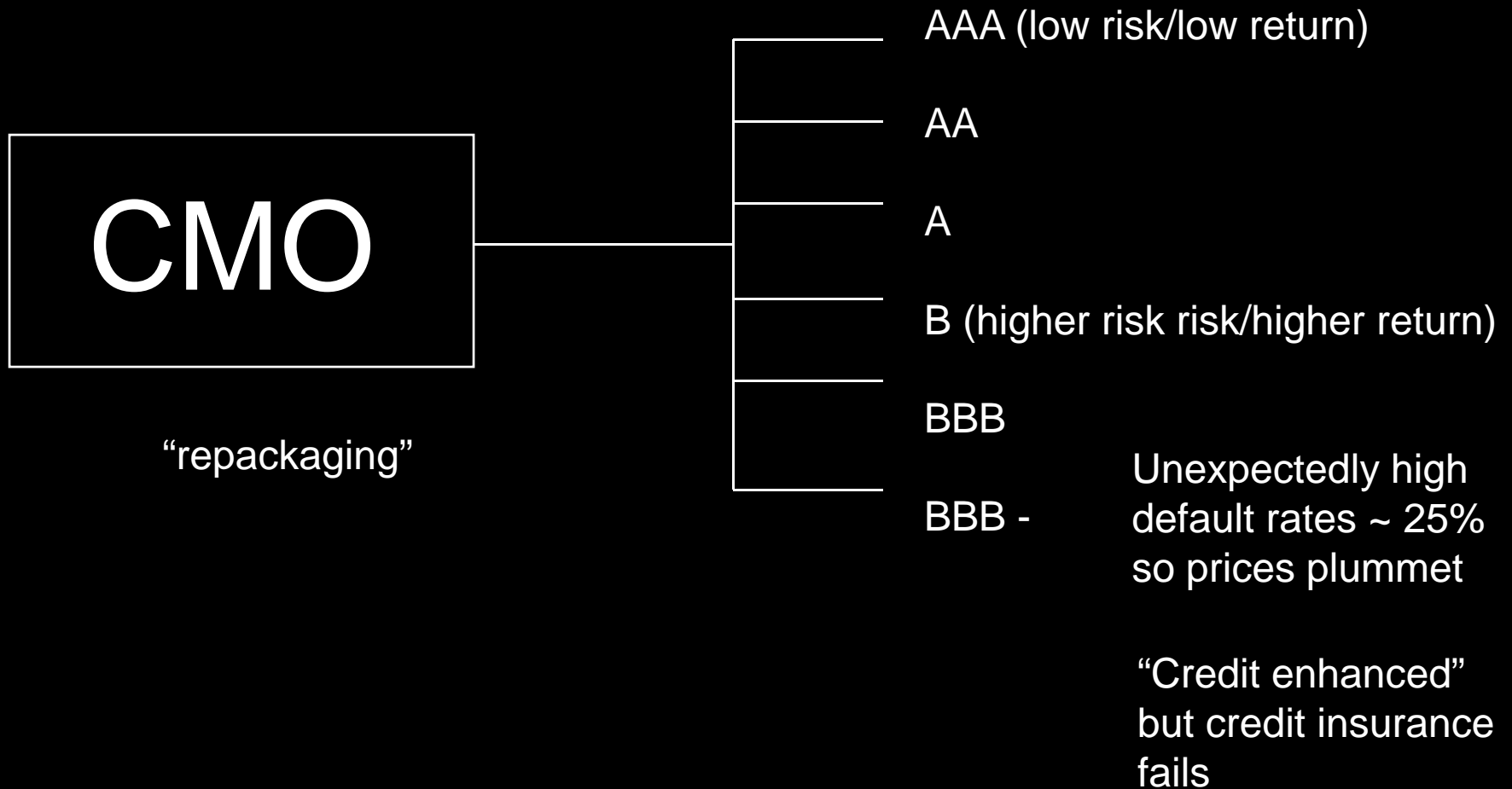
Mortgage Backed Securities



Collateralized Mortgage Obligations, etc.



Broken Up Into “Tranches”



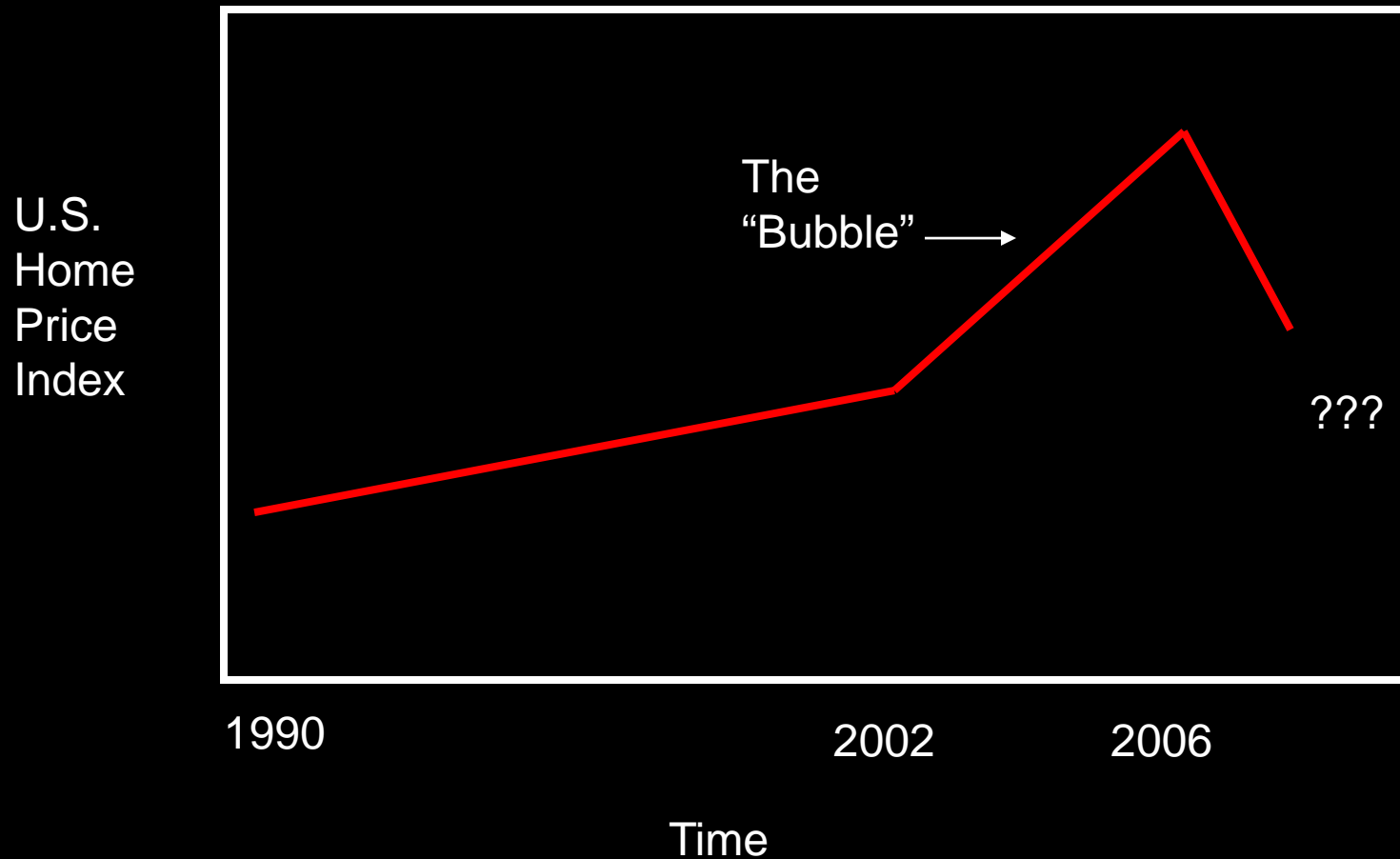
Investment Bank's Balance Sheet **Now**

Assets (things owNed)		Liabilities (things oWed)	
Cash	\$1 billion	Long term borrowings	\$50 billion
Buildings	\$1 billion	Short term borrowings	\$40 billion
Treasury bonds	\$10 billion		
Other assets	\$68 billion		
CMOs	\$10 billion		
	\$100 billion		
	\$90 billion		\$90 billion
		NET WORTH (A-L) = \$0	
		<ul style="list-style-type: none"> *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

Assets (things owned)		Liabilities (things owed)	
Cash	\$1 billion	Long term borrowings	\$50 billion
Buildings	\$1 billion	Short term borrowings	\$40 billion
Treasury bonds	\$10 billion		
Other assets	\$68 billion		
CMOs	\$??? billion		
	\$100 billion		
	\$??? billion		
			\$90 billion
		NET WORTH (A-L) = \$???	
		<ul style="list-style-type: none"> *Short and long term creditors stop lending *Bank must suspend new business *Economy begins to suffer: <ul style="list-style-type: none"> -real GDP decline -increased unemployment -more mortgage defaults ... 	

Why Are Default Rates So High?



Why Are Default Rates So High?

2. 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.

Who Should We Blame?

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.