

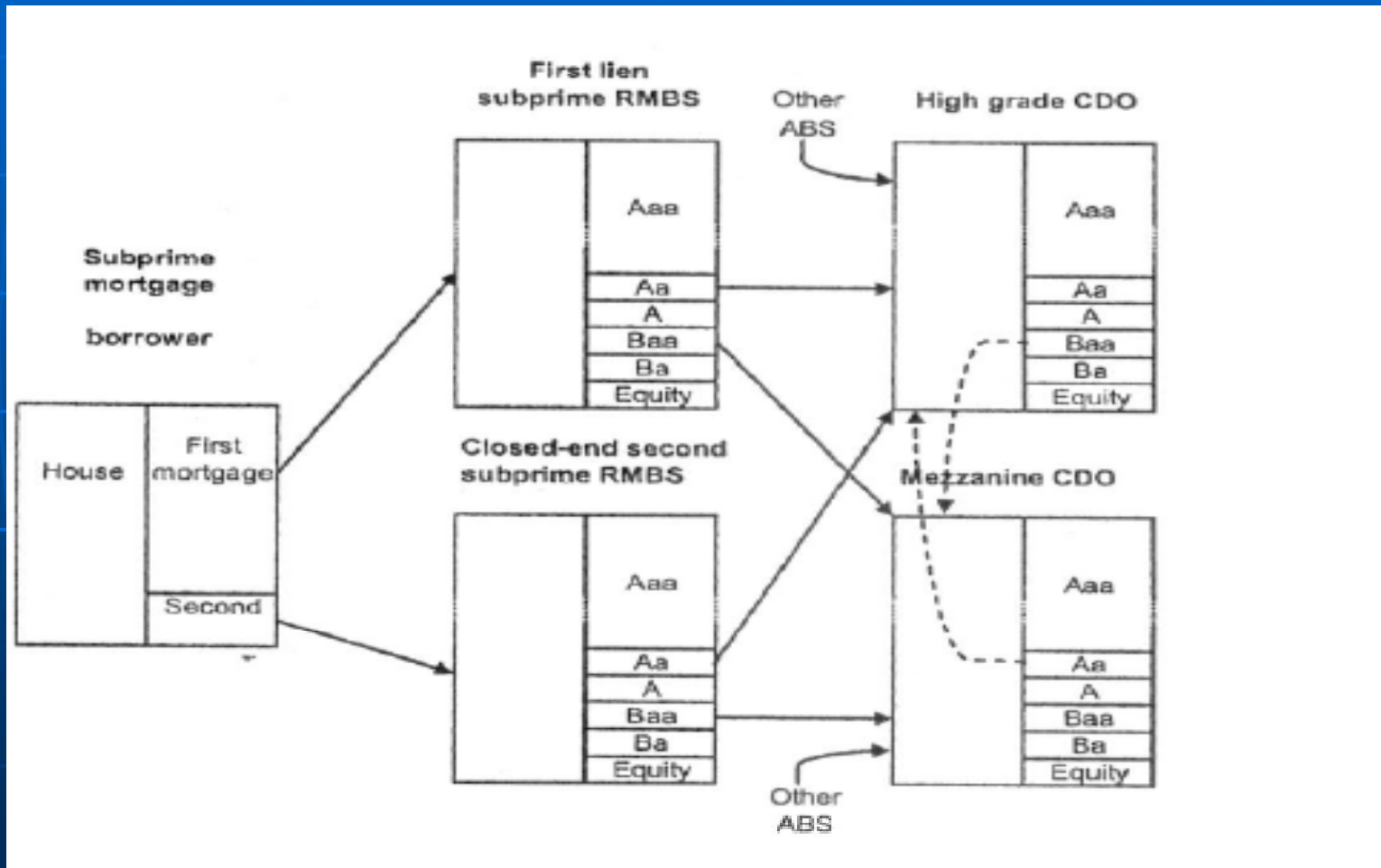
The Financial Crisis: Causes, Responses, and Implications

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July 21, 2009

What Happened: Multiple Causes

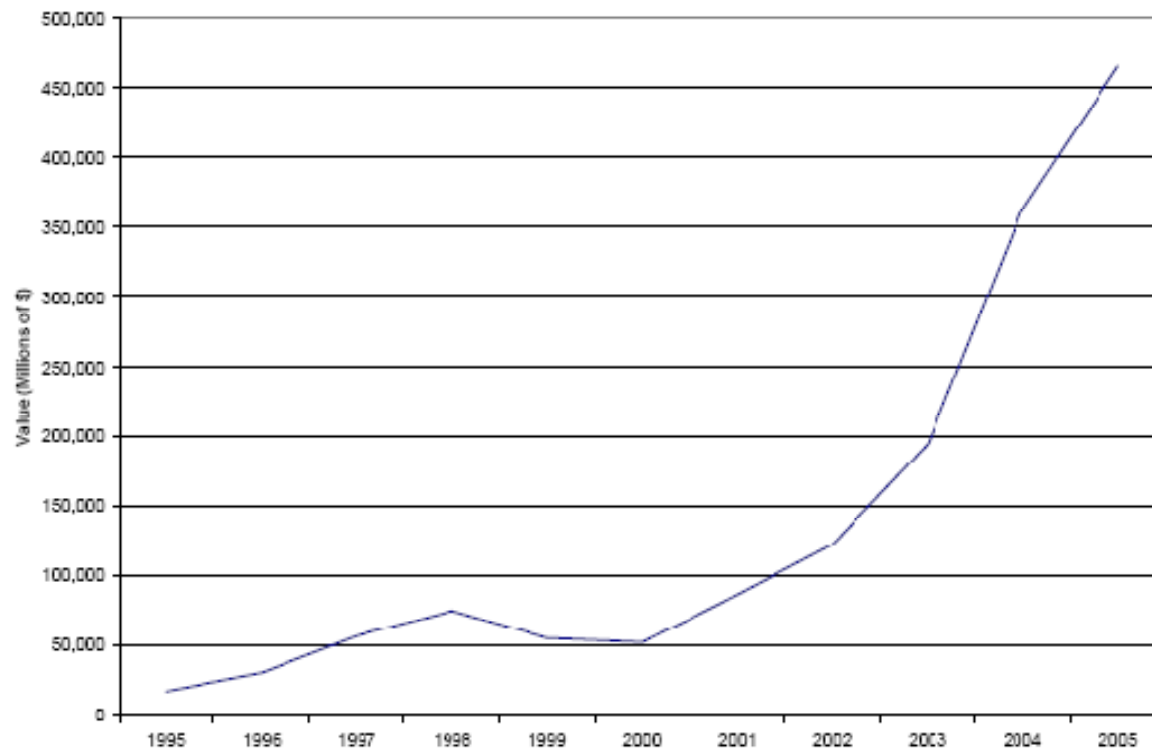
- The Greenspan Gamble
 - Fed: Lower interest rates to help recovery from the tech bubble
- Mortgage Market and Funding Innovations
 - CDOs, SIVs, expanded derivatives markets
 - Increased reliance on mortgage brokers
- Loose Regulation
 - Banks, Fannie/Freddie, others, minimized capital
 - Regulators (SEC, etc.) and cheerleaders (HUD, etc.) abetted the boom
- Standards became lax
 - Underwriting, rating agencies, disclosures
- Rust (Auto) Belt in recession

The CDO



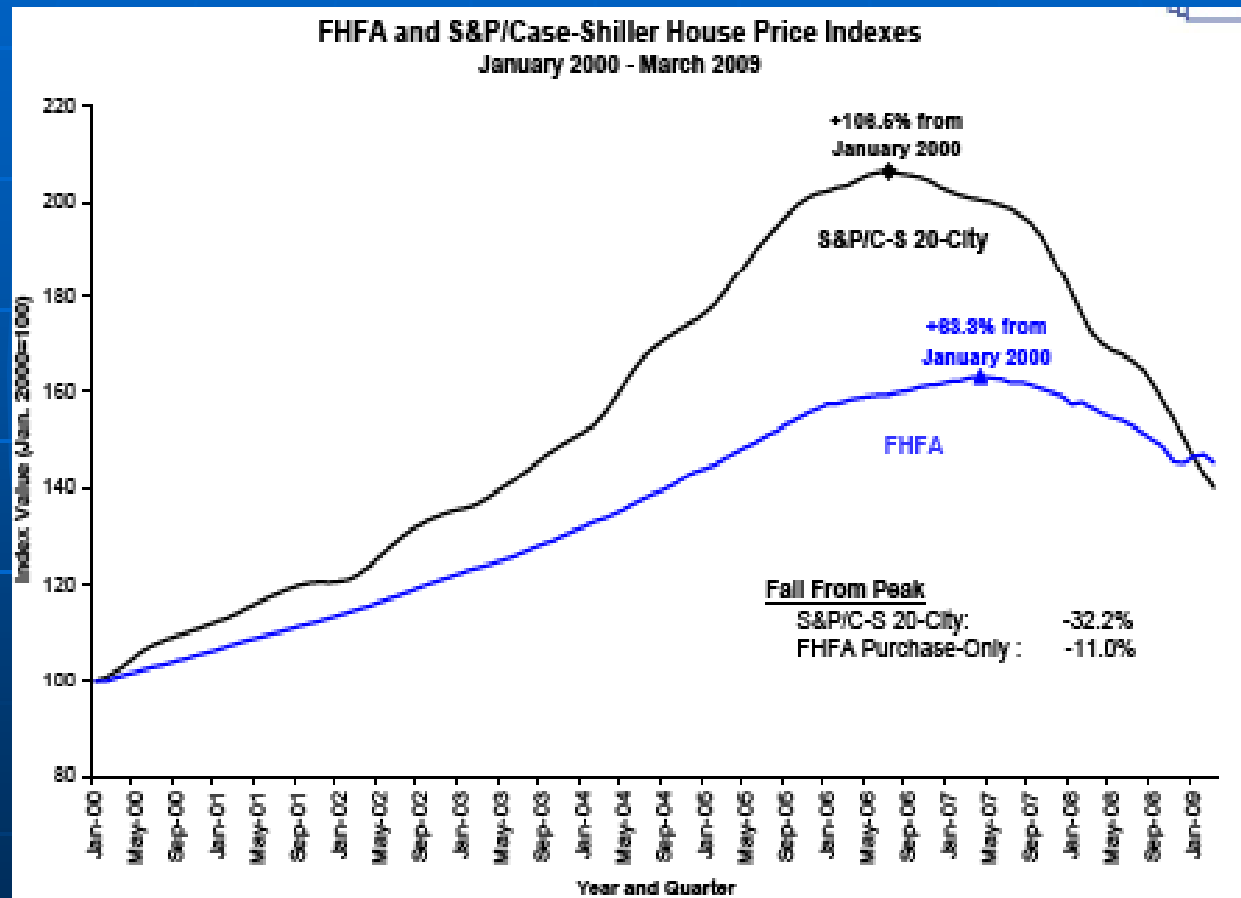
Funding the American Dream

Figure 2. Subprime Mortgage-Backed Securities

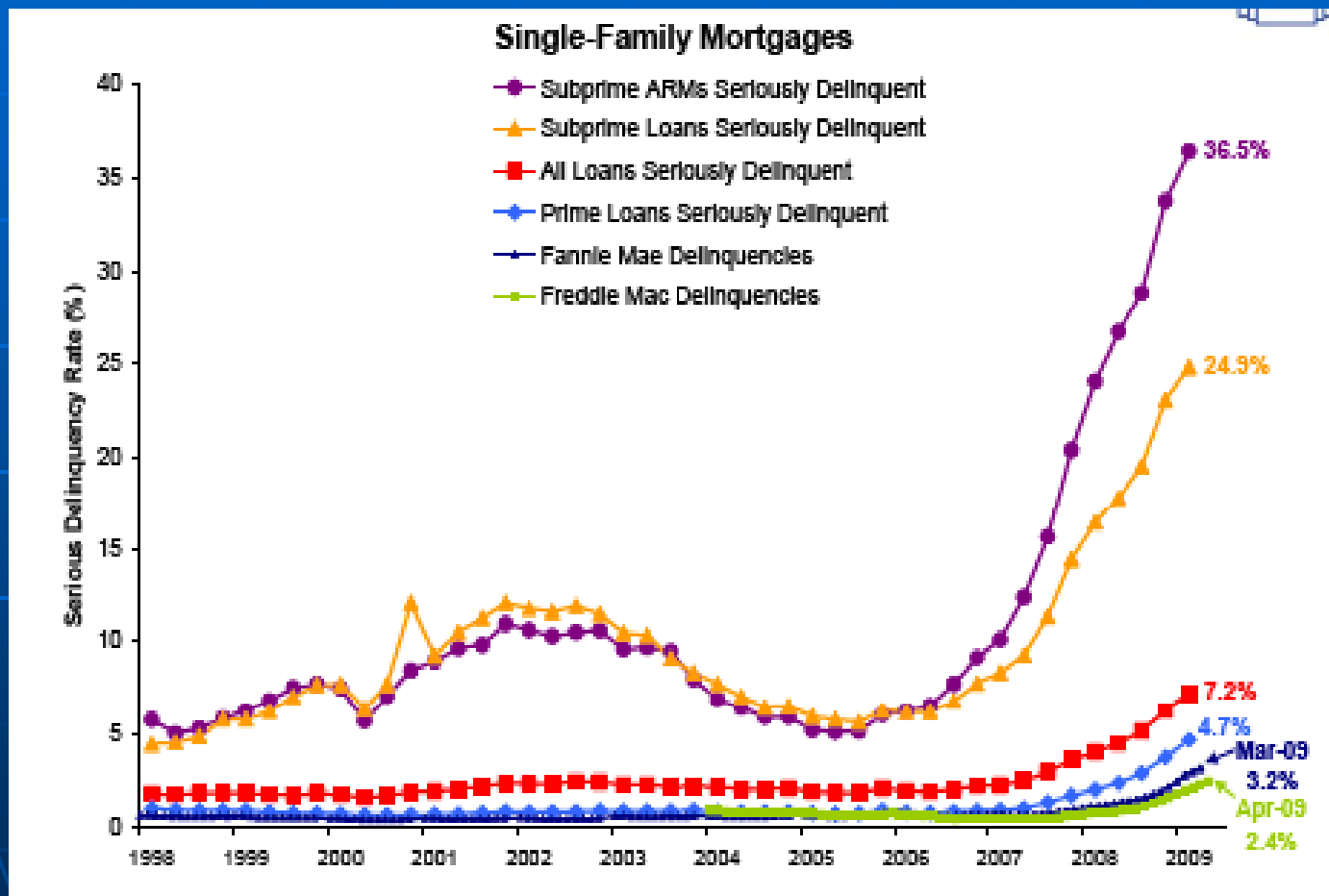


Source: Inside Mortgage Finance, *2007 Mortgage Market Statistical Annual*, vol 1., p. 3.

The Housing Bubble

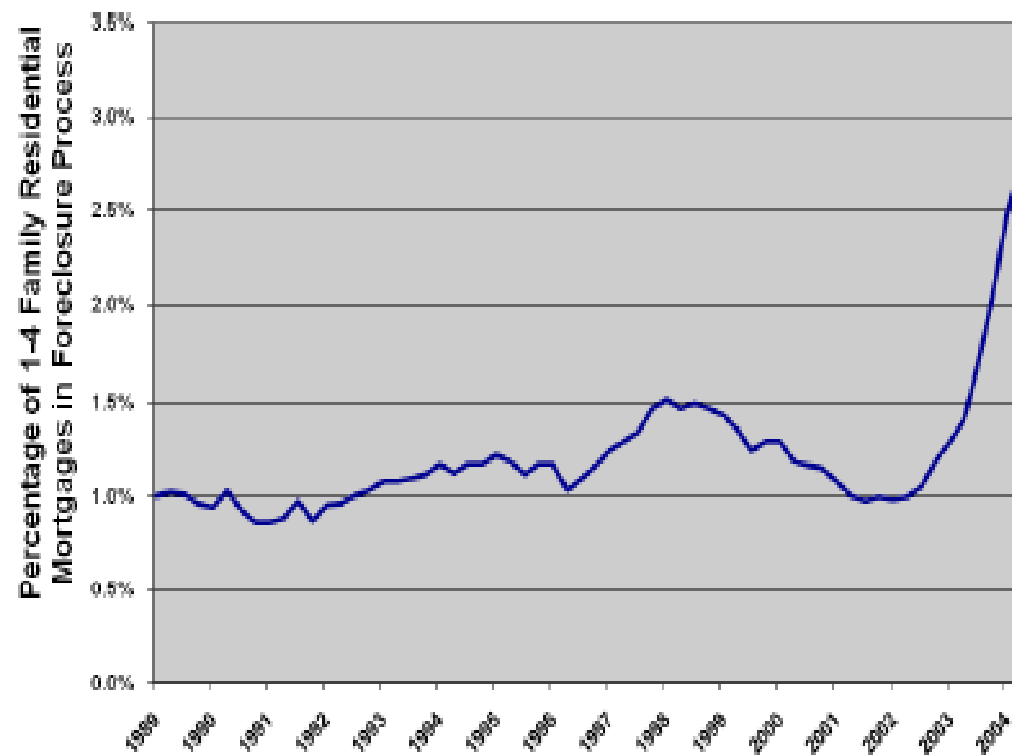


Then Misfortune



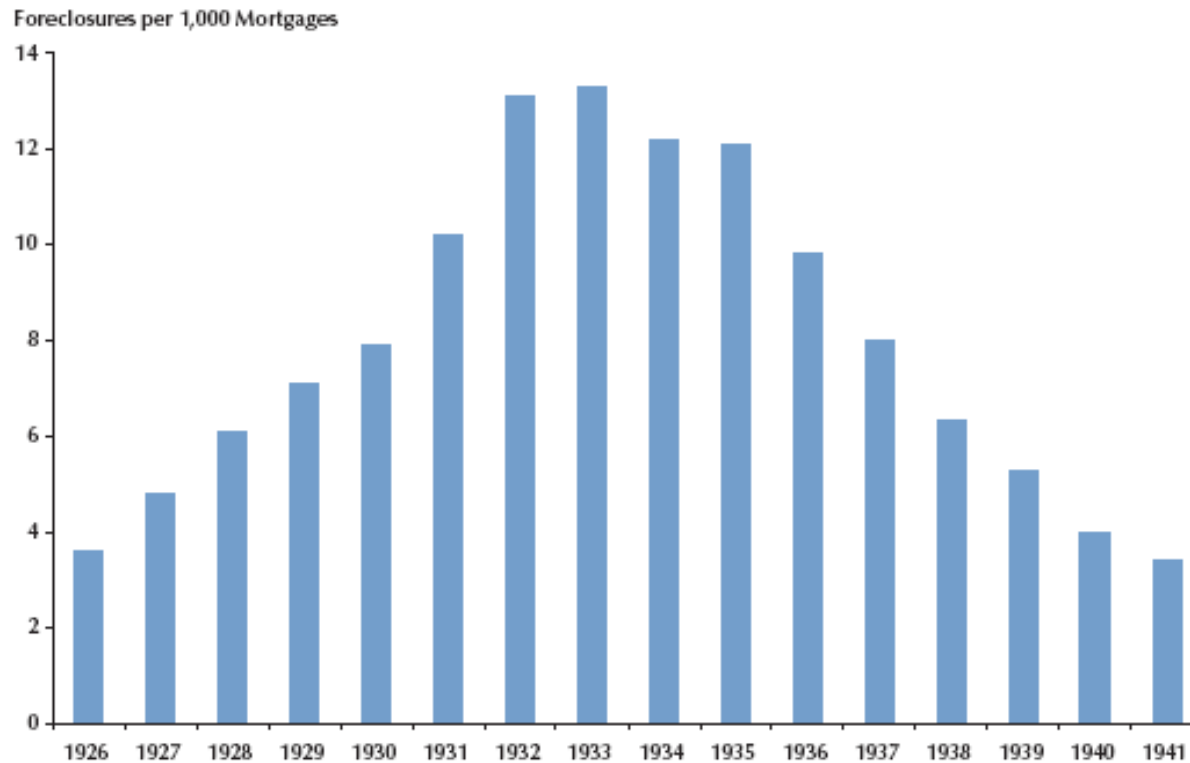
And More Misfortune

Chart 1: Percentage of 1-4 Family Residential Mortgages in Foreclosure Process¹⁷

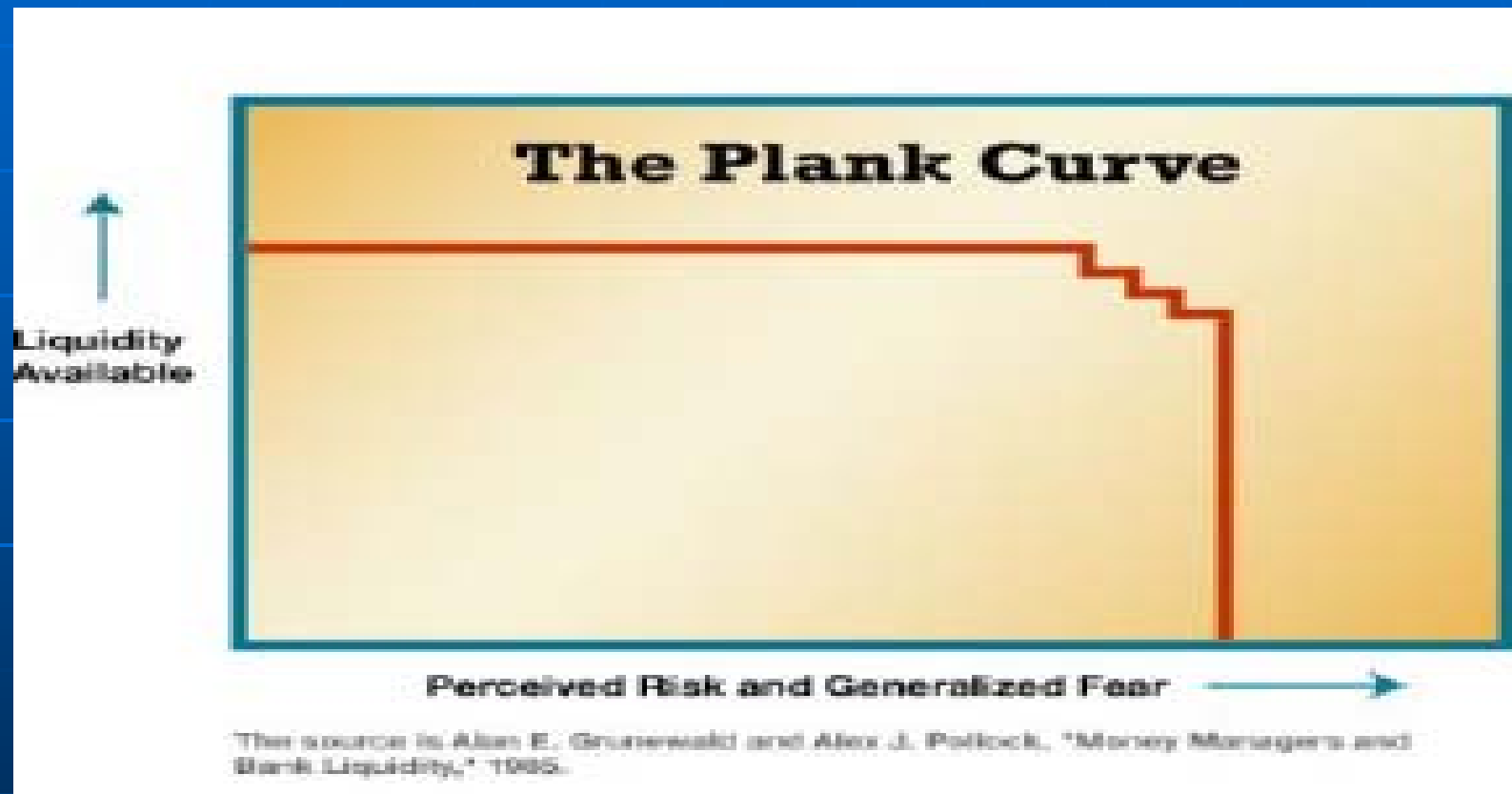


The Great Depression was Much Worse

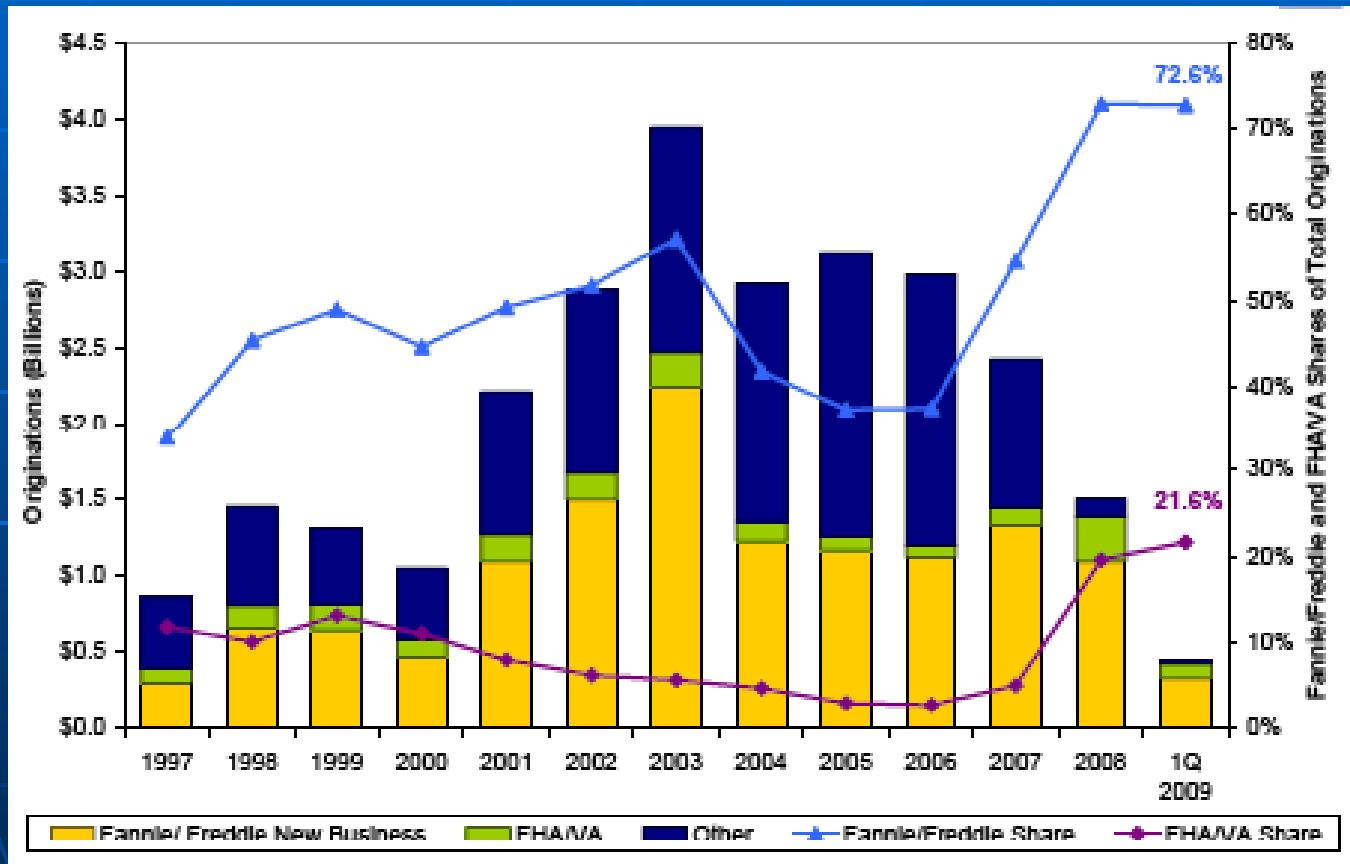
Nonfarm Real Estate Mortgage Foreclosure Rate, 1926-41



The Dominoes Fall: The Liquidity Crisis



Fannie Mae/Freddie Mac and FHA/VA Market Share (Originations)



Policy Issues

- Debacle has outrun policymakers
 - (1) Mortgages, (2) Financial, (3) Economic
 - Mortgages: Three waves of foreclosures
 - Financial: (1) Inability to value assets, (2) Insolvent institutions, (3) Global linkages
 - Economic: Excess capacity
- Government lacks capacity (e.g., FHA)
- Crisis of Legitimacy (e.g., who is bailed out, process perceptions, who is at fault)

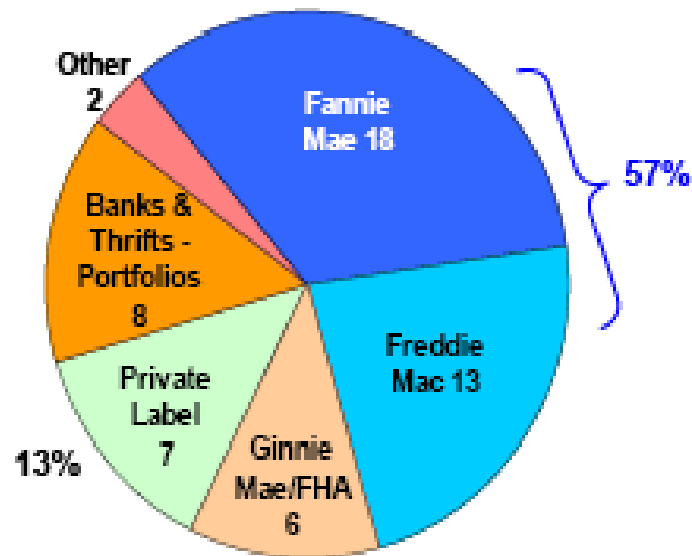
Policy Issues

- How to resolve insolvent institutions
 - Warren Buffett: "...our cost of borrowing is now *far* higher than competitors with shaky balance sheets but government backing. At the moment, it is much better to be a financial cripple with a government guarantee than a Gibraltar without one."
- How to cushion foreclosure of insolvent homeowners
 - New plans help millions; but not people who lose jobs, most private securitized mortgages, etc.

Foreclosure Mitigation Programs

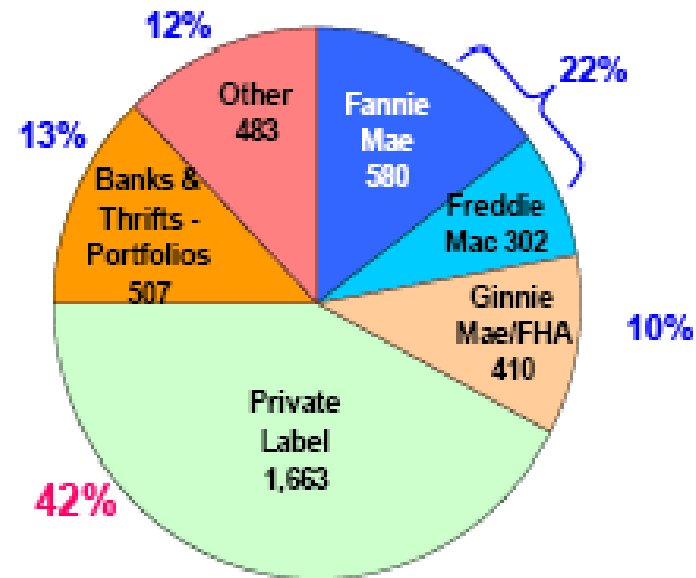
Q1 2009

Mortgages Outstanding
(millions)



Total: 54.5 million

Seriously Delinquent Mortgages
(thousands)



Total: 3.9 million

Where do we go from here?-

- The problem of institutions too big to fail/too big to manage
- Regulating financial markets and Stanton's Law:
 - “Risk migrates to the place where government is least equipped to deal with it”
- Modest Proposal: NTSB for financial system

Comforting Thoughts

As the Fed got organized in 1914, hopes were high for what it would accomplish. The Comptroller of the Currency expressed the view that with the new Federal Reserve, "financial and commercial crises or panics seem to be mathematically impossible."

-- Alex Pollock, 2008

How can we help?

“I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders”

-- Alan Greenspan, 2008

- The impact on young professionals

The New \$ 1 Bill

