Podcast Script

Episode 2: Origins of the Crisis

Moderator Introduction	**Diane:** Hello again. My name is Diane Ellis. Welcome to Episode 2 of the FDIC's ongoing podcast of *Crisis and Response: An FDIC History, 2008-2013*. [pause]
What This Episode Will Cover	**Diane:** Episode 1 laid some of the groundwork for this series. It discussed how the progression of the crisis – from the 2008 financial crisis to the banking crisis that followed – shaped the structure of our study. Our study is a 10-year look-back on the crisis that emphasizes the FDIC's unique combination of responsibilities for bank supervision, deposit insurance, and the resolution of failed institutions. Today's discussion will focus on the *Origins of the Crisis*, which makes up Chapter 1 of the study. How did things move so quickly from a period of apparent prosperity and growth to a breakdown that brought the financial system to a standstill?

Introduce Fred and Rich	**Diane:** Joining me today are two of the FDIC's most senior economists, who played significant roles in identifying and addressing the crisis a decade ago. Fred Carns is Principal Advisor in the FDIC's Division of Insurance and Research. Welcome Fred. - Thanks Diane. And Rich Brown is the FDIC's Chief Economist. - Good to be here, Diane.
Central Question: What Caused the Financial Crisis?	**Diane:** So let's get right to the point. What do you all see as the primary cause of the financial crisis? **Fred:** Well, there were a number of causes. First was the surge in the volume of risky subprime and nontraditional mortgages. You can get more detailed definitions of these mortgages in the *Crisis and Response* study. Suffice it to say here that they were much riskier than prime mortgages. We also saw private financial instruments – including asset-

	backed securities and derivatives based on them – that ended up spreading the risk of these mortgages around the system. • These private, asset-backed securities were the main vehicle for funding subprime and nontraditional mortgages. And finally we saw weak institutional structures – including undercapitalized banks and non-banks funded by overnight money – that turned out to be highly exposed to these risks. **Rich:** That's right Fred. That ended up being a lethal combination of factors. But the crisis really cannot be described as an external event that rolled in and caught everyone by surprise. It was really manufactured from within the financial sector itself. Weak lending practices and shaky institutional structures – many of which were outside of the regulatory framework – were profitable for a while but also injected tremendous risk into the financial system. An important lesson that we learned all over again during the crisis is how important a stable financial system is to the real economy. A modern economy simply can't function without the support of a stable financial system where you can make payments, obtain credit, and carry out other everyday transactions.

The Crisis Originated from <u>Within</u> the Financial Sector	**Diane:** So let me understand Rich. You're saying that the financial sector itself caused financial instability that led to the crisis? What do you think Fred? **Fred:** Well Diane as strange as it sounds, that's essentially what happened. Home prices had started rising in about 1996, and the boom really took off when mortgage rates hit a low point in 2003. Prime, fixed-rate mortgages dominated the market as late as 2003. That's when low interest rates created a "once in a lifetime" opportunity for homeowners to refinance or withdraw equity from their homes. What happened next, in 2004, was the abrupt turn toward subprime and nontraditional loans. That's how lenders were able to keep making mortgages after the wave of prime mortgage refinancing ended.
Inherent Incentives to Take Risks	**Rich:** And the way mortgage financing worked before the crisis provided both incentives and opportunities to make risky loans. The riskiest mortgage lending was mainly concentrated in non-bank lenders. They were able to sell these loans to investment companies who "securitized" them – which means issuing securities backed by

	those risky mortgages – and then sold the private, mortgage-backed paper to investors around the world. • The study describes in more detail how this private mortgage-backed securitization process works – or at least how it used to work before the crash. The key point is that the companies that made the risky loans, and those that issued securities against them, both got paid up front. The risk of these loans would not be realized until later, after it had been downstreamed to unsuspecting investors.
Why Risks Were Underestimated	**Diane:** So why do you all think these investors were so naïve about the risks of investing in subprime and nontraditional mortgages? **Fred:** Well there are a couple of reasons that both domestic and foreign investors and regulators underestimated the risks. First, we're talking about securities backed by U.S. mortgage loans. Virtually nobody saw residential mortgage loans as inherently risky. They really never had been since the Great Depression. And U.S. home prices had never declined broadly since the Depression. That was pretty much taken for granted – particularly by foreign investors. Second, the bond rating agencies also seemed to hold this same

	view about mortgage loan risk. They put high ratings on mortgage securities that turned out to vastly underestimate their risks. And third – there was the reach for yield. Short-term interest rates had fallen to their lowest levels since the 1940s. And these mortgage securities seemed to be a relatively safe and easy way to manufacture yield. **Rich:** It seemed like you really couldn't make a bad mortgage loan as long as home prices were rising rapidly. It wasn't until home prices began to fall – in 2006 – that we saw big increases in mortgage defaults and foreclosures. And this credit distress pushed home prices down even more.
Boom and Bust in U.S. Home Prices	**Diane:** So I think that brings us to the boom-bust cycle in U.S. home prices. I recall that concerns about a housing bubble were being voiced as early as 2000. Home prices had risen by about 50 percent in four years in major California markets, and by more than 25 percent in a number of other markets. So the question in front of us at that time was: Is this just a Boom that will eventually fizzle out, or is it a Bubble that will eventually burst and create a major problem for lenders and

	borrowers. **Rich:** Well, that was a question where we tried not to jump to conclusions before we had good evidence of a problem. Through the late 1990s and early 2000s, analysts at the FDIC maintained that it's just a boom period in U.S. housing markets. Nothing extraordinary. When all of that prime, fixed-rate refinancing took place in 2003, we still didn't see any real cause for alarm. Those who refinanced generally had good credit and got a lower payment. This didn't strike us as a big problem.
The Connection Between Risky Mortgage Lending and the Home Price Bubble	**Diane:** So when did you change your view – and why? **Rich:** Well some big shifts in the markets occurred in 2004 that changed our view pretty abruptly. That's when we saw average home prices begin to rise at double-digit rates, and when we also saw mortgage lending shift to much riskier subprime and nontraditional loans. When we pulled all this data together in early 2005, we saw pretty clearly that the housing boom was now being fed by weak credit standards – which is always a red flag for financial regulators. This quickly led to concerns that this boom might turn to a bust

	within a few years, and might result in big increases in credit losses and foreclosures.
The Challenges of Communicating Our Concerns to the Public	**Fred:** You know, I think the trickiest aspect of monitoring what you think might be an asset bubble is what a regulator should communicate to the public on that point, and how. The FDIC's mission – after all – is public confidence. So we're always careful in how we talk to the public about emerging risks. While we wanted to warn investors, lenders and borrowers about the risks we saw in housing markets, we also didn't want to spark a panic reaction that might make things worse. The FDIC released a paper in May 2005 that connected many of the dots between the shift to risky mortgage lending and the acceleration in the housing boom. But I'm not sure you could say we were very successful in communicating this point. **Rich:** Yeah, I agree. In retrospect, any warnings about the mortgage credit cycle fell mostly on deaf ears, while home prices were still rising. The realization that home prices were falling and mortgage credit was becoming a problem didn't really occur until the late summer of 2006. At that point, I'm afraid the die was cast.

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<td>How Did the Losses to Mortgage Investors End Up Creating a Wider Financial Crisis?</td>
<td>Diane:

This conversation is reminding me of a line in the Study that describes how “the ripple effects from the troubles in the housing market began to reach deeper into the financial system.”

How do you all think the disruption in market-based mortgage finance ended up transmitting itself into the core of the financial system?

Fred:

Well, first it was the sheer size of the nonprime mortgage market.

By mid-2007, private issuers of asset-backed securities held almost $2.5 trillion in home mortgage loans.

That was 3 or 4 times more than they held in 2003, just four years earlier.

Even more exposure was generated through credit default swaps based on the value of these securities.

And once home prices started falling, that mortgage paper turned out to be much more difficult to value than anticipated.

All investors had was the original rating.

Once it became apparent that the ratings were way too optimistic, it was anybody’s guess what these instruments were worth.

Rich:

Well, Yes. And the problem was that these securities and derivatives, which had been so popular when investors were searching for yield, were now on the books of banks, investment companies, pension funds, money market funds – you name it – all over the financial system and around the world.</td>
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	Not only did investors begin to distrust the mortgage paper, they also began to distrust the counterparties that they thought might hold this mortgage paper. So it was a vicious circle. And it was further amplified by the deleveraging of financial companies and the fire sales of distressed assets.
How “Shadow Banking” Amplified the Crisis	**Diane:** And speaking of the vicious circle, I think this is the point in the conversation where we should bring in one of the most important factors that contributed to the crisis, and that is the rise of what some people call the “shadow banking” sector. You saw a large number of investment companies, special purpose vehicles, and other financial structures that were not only highly leveraged, but also relied on short-term funding. This funding was often collateralized – in many cases by the same mortgage-related assets we’ve been talking about. And these short-term funding sources needed to be rolled over frequently – sometimes even daily. It was in the summer of 2007, when the value of mortgage-backed securities fell into doubt, and that these shadow banks began to have major problems funding themselves. I think that is when we really began to see problems reach deeper into the financial system.
The Run on Shadow Banking	**Fred:** Exactly.

	Liquidity – which is the ability to fund your balance sheet and meet your day-to-day obligations – really started to become a widespread problem. And that's the definition of a financial crisis – when market illiquidity and distrust between counterparties reinforce one another in a downward spiral. There is really nothing else to call it but a panic. This is exactly the type of situation that the FDIC was created to prevent, by removing the incentive for insured depositors to run on the bank. The difference in this crisis was that the "run" was on "shadow banks" whose short-term liabilities were not insured and were not even deposits. This was something we had never seen before.
Measuring Illiquidity in the Inter-Bank Funding Market	**Rich:** The study includes a chart of the so-called "TED Spread," or the difference between the London Interbank Offer Rate and the yield on 3-month U.S. Treasury securities. Now this spread generally hovers around 25 basis points, or a quarter of 1 percent, in normal times. But it began to blow out in late 2007, exceeding 100 basis points. And it reached a peak of 464 basis points – more than 4 and a half percent – at the height of the crises in September 2008. This is one of the most reliable measures of systemic financial distress that you are going to find. But at the height of the crisis, some referred to it as "the rate at which banks would not lend to one another."

The Search for Solutions to the Crisis	**Fred:** Right. Of course, the Federal Reserve did see this problem early on, and it began introducing a series of programs to provide liquidity – not just to banks but to a wider range of financial companies. That certainly helped. But it really didn't fix the underlying problem. **Rich:** By the end of the summer, in 2008, policymakers were starting to look around for a larger solution to these systemic problems – something that could form a "fire break" and keep the problem from getting bigger. And we heard some ideas from outside groups for some type of larger fund, with wide-ranging powers, that could act decisively and restore order. But, frankly, this was something that was considered a "first 100 days" project for the next administration. As it turned out, we didn't have that much time.
The Culmination of the Financial Crisis	**Diane:** No, we certainly didn't. The chain of bad news that had started in 2007 finally culminated in September 2008 – a period that is now forever seared into the national consciousness. It was then that we saw the government-sponsored mortgage enterprises – Fannie Mae and Freddie Mac – taken into conservatorship.

	By the end of the month, we saw the largest failure in the history of the FDIC – Washington Mutual Bank – and even larger, systemically-important banks requiring assistance. You can find a detailed timeline of these and other events in our *Crisis and Response* study. But it was clearly the September 15th bankruptcy of Lehman Brothers – a shadow bank that was heavily exposed to mortgage risk – that stands out as the defining event of the crisis. **Fred:** Yeah, It was widely understood that Lehman Brothers was in trouble. But the market seemed to expect that – because Lehman had such wide connections to the global financial system – U.S. policymakers would never allow it to fail. So the financial markets were stunned, to say the least, when Lehman was allowed to file for bankruptcy. And that's when general concern turned into outright fear. Financial institutions seemed to lose all confidence in one another. The TED spread peaked, and the systemic crisis was upon us. **Diane:** And that will be another story that we will explore further in the next episode of the podcast. Fred, Rich – Is there anything that you would like to add before we close?
When Did You Realize That This Would Be	**Rich:** Diane, as we were talking through the *Origins of the Crisis*, I

a Major Financial Event?	couldn't help but wonder what both of you would consider your own personal experience during this time. And we all saw that perpetual string of bad news from the mortgage markets and the capital markets. But I think most of us can recall one particular event that stood out as a sign that this wasn't going to be a garden variety market event – that this was going to be the Big One. Diane, what was it for you? **Diane:** Yeah, Sure. For me, I think that event was the failure of IndyMac Bank, in July 2008. Until then, we had seen a string of events that pointed to the risks outside of the banking industry. But IndyMac was a $33 billion FDIC-insured institution – a nontraditional mortgage lender in California – that ended up being the most costly failure in the history of the FDIC. It had been 15 years since the failure of such a large bank. Not only was that a bit of a shock to those of us at the FDIC, it was also an unpleasant surprise to IndyMac depositors, who – despite being insured - participated in a "run" on the bank before it was closed. That's when many of us first tasted the fear that this was a true crisis. **Fred:** For me, I guess it was the September 2008 run on the Prime Reserve Fund – a money market fund.

	Before Prime Reserve “broke the buck,” as they say, these money market funds were deemed as providing a terrific combination of safety, liquidity, and yield. As it turns out, many of their account holders were surprised to learn that the fund was directly exposed to losses from the Lehman Brothers bankruptcy. And as the market became aware of that exposure, you also began to see a “run” by their depositors. Of course, these money market funds didn’t have deposit insurance. Nobody thought they would ever need it. But after Prime Reserve, money market funds instantly got full backing by the Treasury – to keep the situation from getting worse. For me, this was when the magnitude and the reach of the crisis really came into full view. **Diane:** So Rich, that was a good question. What about you? What was your moment of realization that this could be the Big One? **Rich:** For me, I suppose it was the collapse of Bear Stearns, in March of 2008. This was a highly regarded, highly successful Wall Street company that did business with prominent customers around the world. They were very well known for their market expertise. But they just got it spectacularly wrong when it came to private

	mortgage exposures. So to me, that's when it first seemed possible that the mortgage crisis could reach right into the heart of the financial system, which it eventually did.
Closing Remarks	**Diane:** Right. Well, this is where we will leave the *Origins of the Crisis*. But this is not the end of the story. In fact, it's just the beginning. Our next episode will begin to lay out the *Response to the Crisis*, which required a group effort on the part of the FDIC, the Federal Reserve, and the Treasury to restore order to financial institutions and markets. Our account in Episode 3 will center on an FDIC authority referred to as the "Systemic Risk Exception." On behalf of my colleagues Fred Carns and Rich Brown, this is Diane Ellis – thanking you for joining us for Episode 2 of the FDIC's *Crisis and Response* podcast.