



The origins of the sub-prime crisis: Inappropriate policies, regulations, or both?

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ABSTRACT

This article analyses the origins of the sub-prime crisis. It argues that a series of serious policy errors in the United States created the conditions in which the sub-prime lending phenomenon took root, which were then compounded by regulatory developments and further policy mistakes as the credit crisis unfolded. These factors further explain why the sub-prime crisis assumed such global proportions.

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1. A synopsis of the sub-prime crisis

At the outset of 2008 it was probably fair to conclude, as one commentator (Mathieson, 2008) observed, that few people outside the United States had heard the phrase 'sub-prime', except perhaps in the context of a cut of beef steak. Now the expression is known globally. Yet, despite this familiarity, it continues to surprise how the situation in one segment of the US residential mortgage market could have translated into what has the potential to turn out to be the greatest financial crisis in US history (already the funds pledged by the US government in financial support vastly exceed in inflated adjusted terms the US government spending during World War II),¹ that not only infected banks across the world, but has plunged economies into recession, creating levels of unemployment not seen for decades. One aim of this article is to explain the context in which this has happened and thus examine the origins of the crisis.

Broad details of the sub-prime phenomenon are now part of the folklore. Many banks obliged homeowners' desire to borrow for consumption purposes against the rising value of their houses ('mortgage equity withdrawal'), and assisted others to become first time homeowners, by making loans that in some cases were up to and exceeding 100 per cent of valuation (125 per cent in the case of Northern Rock in the UK) and lent to those with almost no chance of repayment once the initial 'teaser' rates adjusted to the much higher contracted levels buried away in the fine print. So was born the NINJA borrower (no income, no job and assets). By 2006, nearly 50 per cent of new US home loans were ones that did not qualify for insurance by the mortgage insurers, Fannie Mae or Freddie Mac ('sub-prime' loans) or loans that were higher quality than sub-prime but did not qualify for insurance because of little ('low doc') or no ('no doc') documentation (the 'Alt-A' mortgages). To no-one's surprise, surveys have revealed that more than one-half of such borrowers put a gloss on their income, assets and credit history. CDOs (collateralised debt obligations) packaged these individual loans into securities so complex that they misled credit ratings agencies, investors and the banks themselves. Issuing banks sometimes offered

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¹ Excluding the Obama initiatives, the cost of the monies pledged by the US government in the sub-prime crisis was estimated as US\$4.62 trillion. The only event that comes close to this figure is the US government spending during World War II which was US\$288 billion or an inflation-adjusted figure of US \$3.6 trillion in current terms. By comparison, adding together the cost of the Marshall Plan, the Louisiana Purchase, the race to the moon and all NASA spending, the savings and loan crisis, the Korean, Vietnam and Iraq wars gives an inflation-adjusted figure that amounts to US \$3.9 trillion, still less than the current crisis (Hughes, 2008).

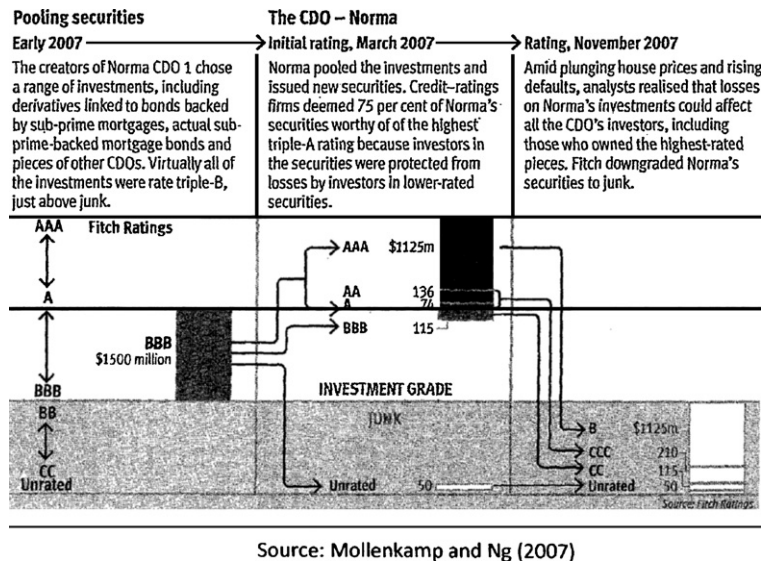


Fig. 1. The rise and fall of Norma CDO1.

guarantees ('liquidity puts') to those buying CDOs that they thought would never be exercised, but came back to haunt them.²

In the description of Axel Weber, President of Deutsche Bundesbank, a number of different reasons, or a 'cocktail of causes', triggered the shock waves that engulfed the global financial system (Weber, 2008). Three main reasons were identified: lax lending standards, weaknesses in the credit transfer processes, and overly optimistic assessments of structured securities such as CDOs. He found as quite 'strange' the idea that borrowers with little or no capital and a poor credit history could obtain a real estate loan. That observation, in turn, prompted Weber to point to weaknesses in the credit risk transfer process via securitization that seemingly made lenders and investors, if not oblivious to risk, confident that credit risks had been divided up, parcelled out and thus transferred appropriately across the financial markets. Indeed, as Weber noted, it appeared for a while that unstable individual loans could be converted into virtually fail-safe securities through structured financing and trancheing. In effect, with financial alchemy, 'vin de pays' could be made into 'cru'. As John Kay (2007) observed, the underlying assumption was that in every B-rated bond there is A-rated and C-rated paper waiting to get out. Discard the C and the B can become an A. Fig. 1 illustrates this process in the case of Norma CDO1 managed by NIR Capital Management and underwritten by Merrill Lynch.³ The course of the ratings experience of this CDO, in which three-quarters of the \$1.5 billion triple-B securities obtained an initial triple-A rating that was downgraded 8 months later to 'junk', illustrates Weber's third factor, namely that market participants held an overly optimistic assessment of the riskiness of structured securities.

On this account, it is easy to understand why securitization and the fragmentation of the value chain are given a major role in the crisis, and underpin the process of 'financialization' whereby the value of financial assets exceeds that of tangible assets (see article by Colin Haslam in this volume). Consider the example from Kaletsky (2008):

'...before the arrival of 'hyper-finance', if a family wanted a £100,000 mortgage they would go to the Halifax and simply borrow £100,000.

Now consider what would have happened in the new financial world. The family would have borrowed £100,000 from Northern Rock, which would sell £100,000 of bonds to hedge funds, which would buy these bonds with £100,000 borrowed from Bear Stearns, their prime broker, which would raise this money by selling £100,000 of commercial paper to Citibank, which would then borrow £100,000 through the inter-bank market from Halifax.

The original borrower is still the same household and the ultimate lender is still Halifax, but now a £100,000 mortgage has created £500,000 of new debt.'

However, this layering of claims rests on confidence. Once risk aversion takes hold, everyone in the chain of transactions comes under suspicion. In these circumstances, it can be understood how 'from being a vehicle for the distribution of risks

² It has been estimated that \$100 billion of sub-prime linked investments offered a money-back guarantee (*Business Week*, December 10, 2007, p. 026).

³ Norma was a 'mazzanine' CDO because of the middling average credit rating (triple-B) of its investments, most of which were not actual securities but were derivatives such as credit default swaps based on sub-prime residential mortgage-backed securities (Mollenkamp and Ng, 2007). Many investment banks favoured such derivative-based CDOs because they could be put together without buying the underlying securities, and because banks could create a number of CDOs linked to the same mortgage-backed bonds.

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