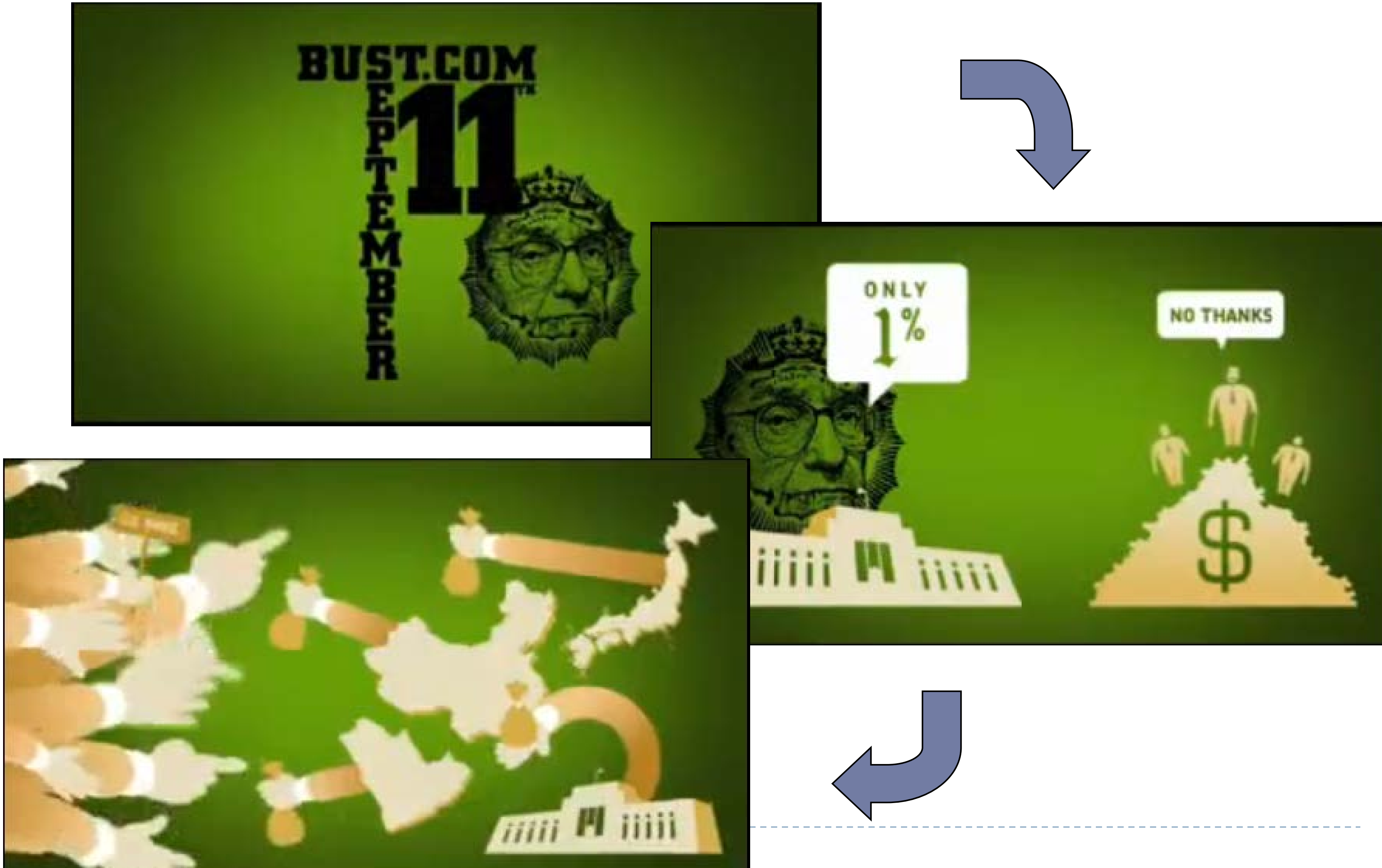
The Subprime Crisis I

Brunnermeier (2009)
Blanchard (2009)

1. Low interest rates and credit boom

- Low interest rates (after 9/11 and .com bubble burst)
- Many countries in Asia and Middle East buy financial assets in U.S.A. to 1) stabilize their currencies against U.S. Dollar and 2) hedge against the weakness of their currencies
- Benign economic environments often lead to credit booms, and to the creation of marginal assets and the issuance of marginal loans (Blanchard, 2009)

1. Low interest rates and credit boom



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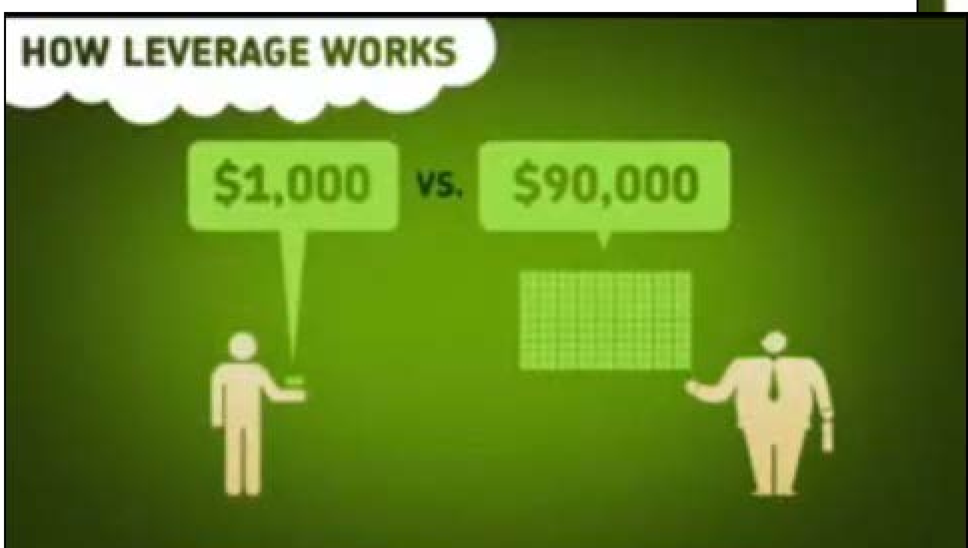

2. Changing banking industry

- Two trends in the banking industry contributed significantly to the lending boom and housing frenzy that laid the foundations for the crisis.
  - First, instead of holding loans on banks' balance sheets, banks moved to an "originate and distribute" model
  - Second, banks increasingly financed their asset holdings with shorter maturity instruments

2.1. Securitization

- banks typically create “structured” products often referred to as *collateralized debt obligations (CDOs)*
  - The first step is to form diversified portfolios of mortgages and other types of loans, corporate bonds, and other assets
  - The next step is to slice these portfolios into different tranches
- Buyers of these tranches can also protect themselves by purchasing *credit default swaps (CDS)*, which are contracts insuring against the default of a particular tranche

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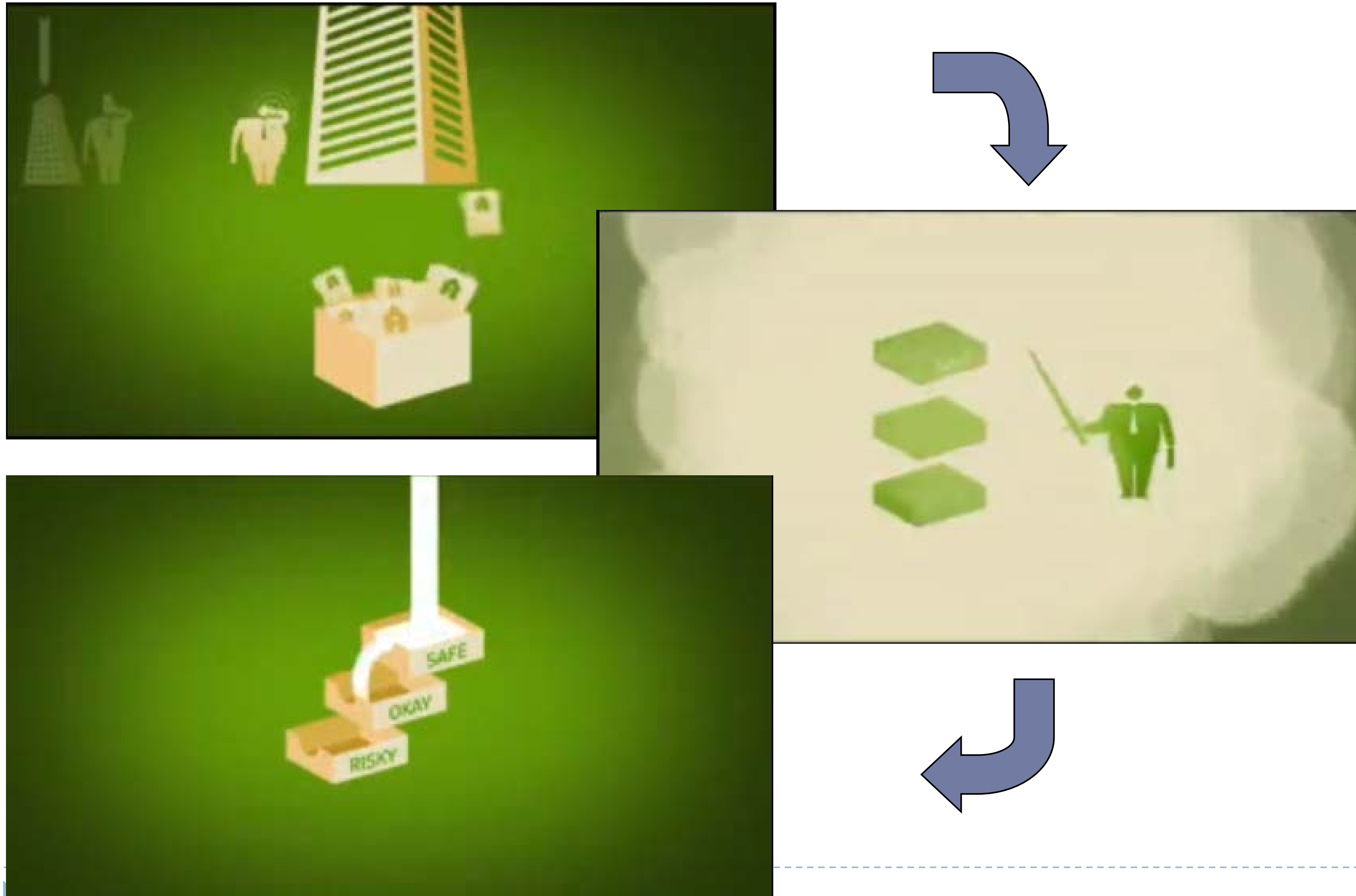

2.2 Shortening the Maturity Structure

- Most investors prefer assets with short maturities, such as short-term money market funds
- Activities was transferred to a “shadow” banking system consisting of off-balance-sheet investment vehicles
- Another important trend was an increase in the maturity mismatch on the balance sheet of investment banks
- These magnify the problem of “Maturity Mismatch”

3. Housing boom

- Conditional on no housing price decline, most subprime mortgages appeared relatively riskless: the value of the mortgage might be high relative to the price of the house, but it would slowly decline over time as prices increased (Blanchard, 2009)
- This combination of cheap credit and low lending standards resulted in the housing frenzy that laid the foundations for the crisis

3. Housing boom

Conditions before the crisis (cont.)

- Abreu and Brunnermeier (2002, 2003):

  It was perceived to be more profitable to ride the wave than to lean against it. (Similar to behavioral finance?)

- "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Youtube link

http://www.youtube.com/watch?v=bx_LWm6_6tA