

# The Financial Turmoil in 2007 and 2008



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# Caveats

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- These views are mine and not necessarily those of the Federal Reserve Bank of Atlanta or the Federal Reserve System.
- I may know quite a bit more about the general developments than you do but I know less than I would like

# Complicated

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- Acronyms
  - ABS, ABCP, CDO, CDO squared, RMBS, SLABS, SIVs, PDCP, TARP
- Operators in markets
  - Monoline insurers
  - Financial institutions all over the world
- Markets
  - Asset-backed securities
  - Auction-rate securities market

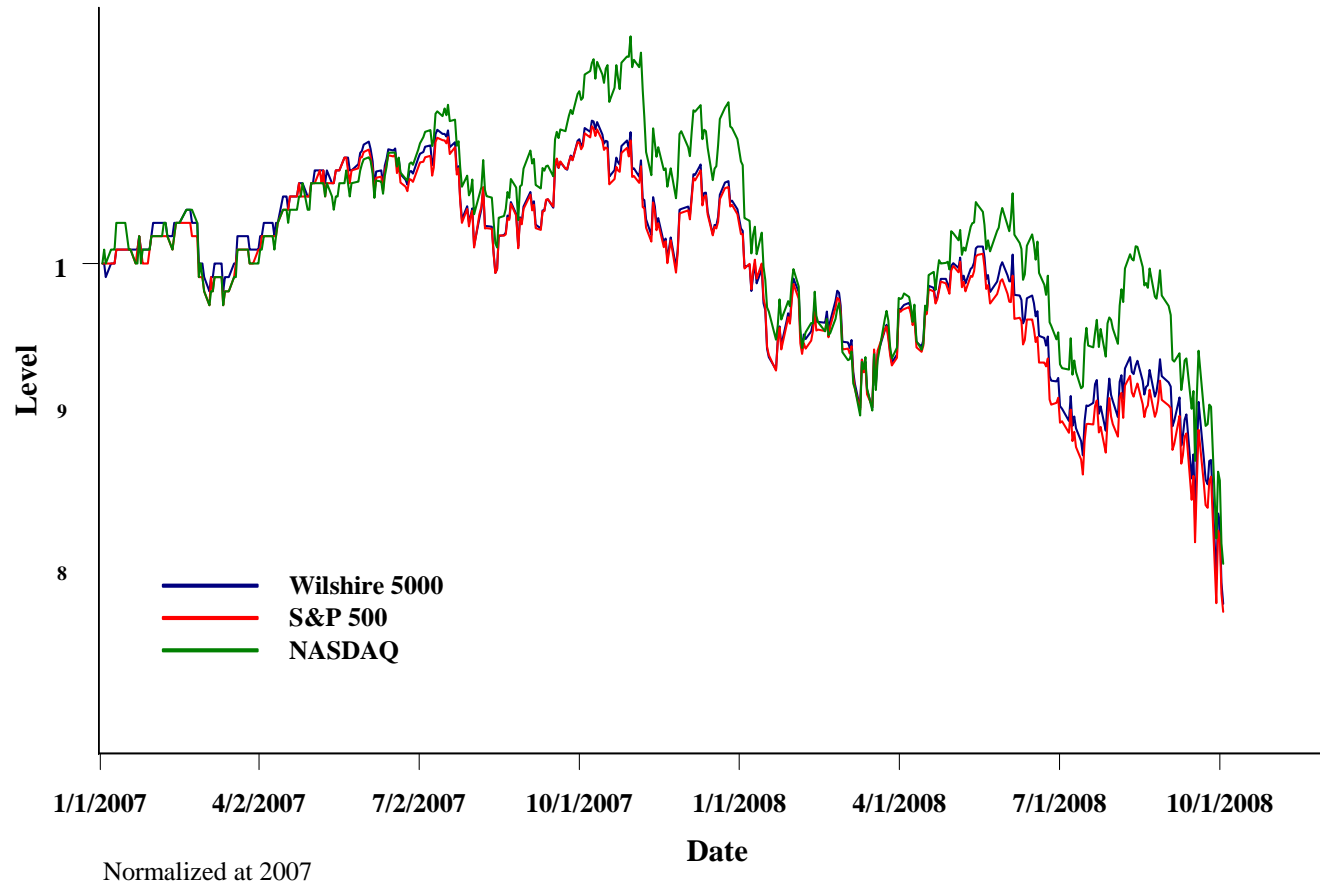
# Story Continues

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- September 14 and 15, 2008
  - Lehman Brothers files for bankruptcy
  - Merrill Lynch bought by Bank of America
- September 16
  - AIG loan up to \$85 billion authorized from Federal Reserve
- Week of September 29
  - Congress passes Emergency Economic Stabilization Act to buy \$250-\$700 billion of assets
  - Wachovia bought by Citigroup, Wells Fargo or both
  - Ireland guaranteed liabilities of Irish banks
- October 5 and 6
  - Germany, Norway and Austria guaranteed deposits in banks

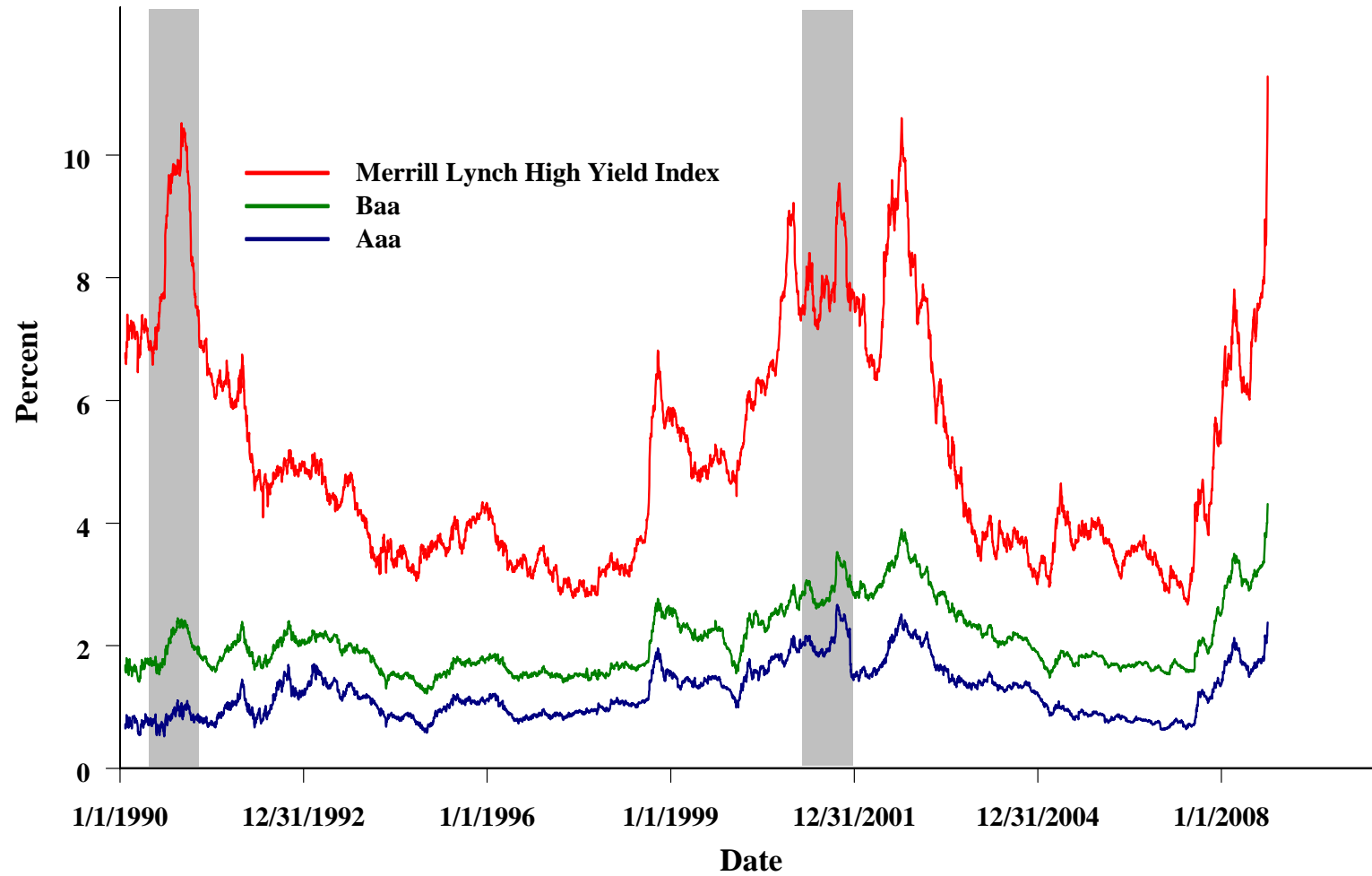
# Stock Exchange Indexes

*January 2, 2007 through October 3, 2008*



# Corporate Bond Spreads over Ten-Year Treasury Yield

*February 1, 1990 through October 3, 2008*



Shaded bars: NBER Business Cycle Contractions

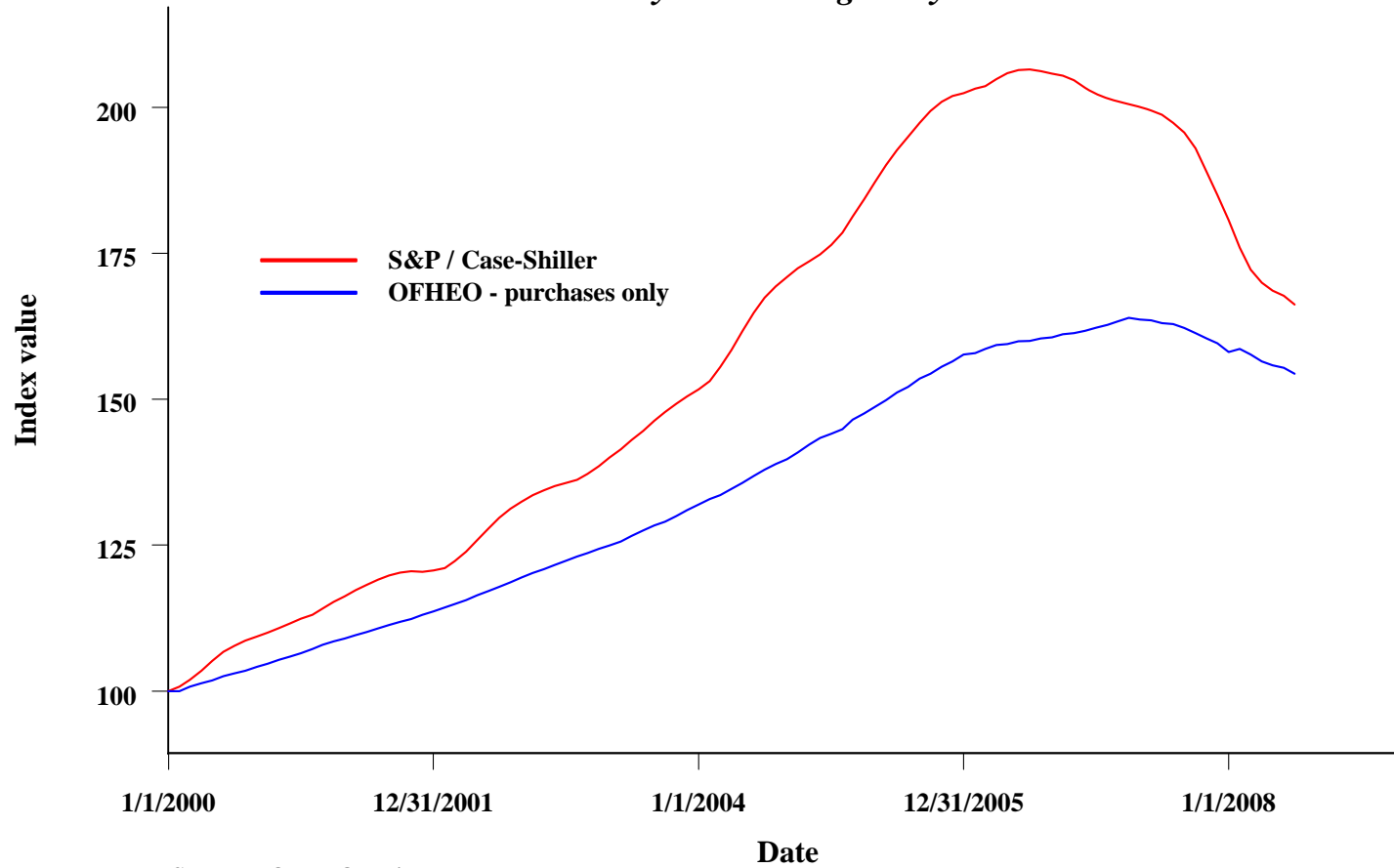
# Background

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- Defaults on mortgages, especially subprime
  - More such loans than historically
  - Relatively low risk spreads
- How do we get from defaults on high-risk mortgages to all this widespread difficulty?

# Housing Price Indices

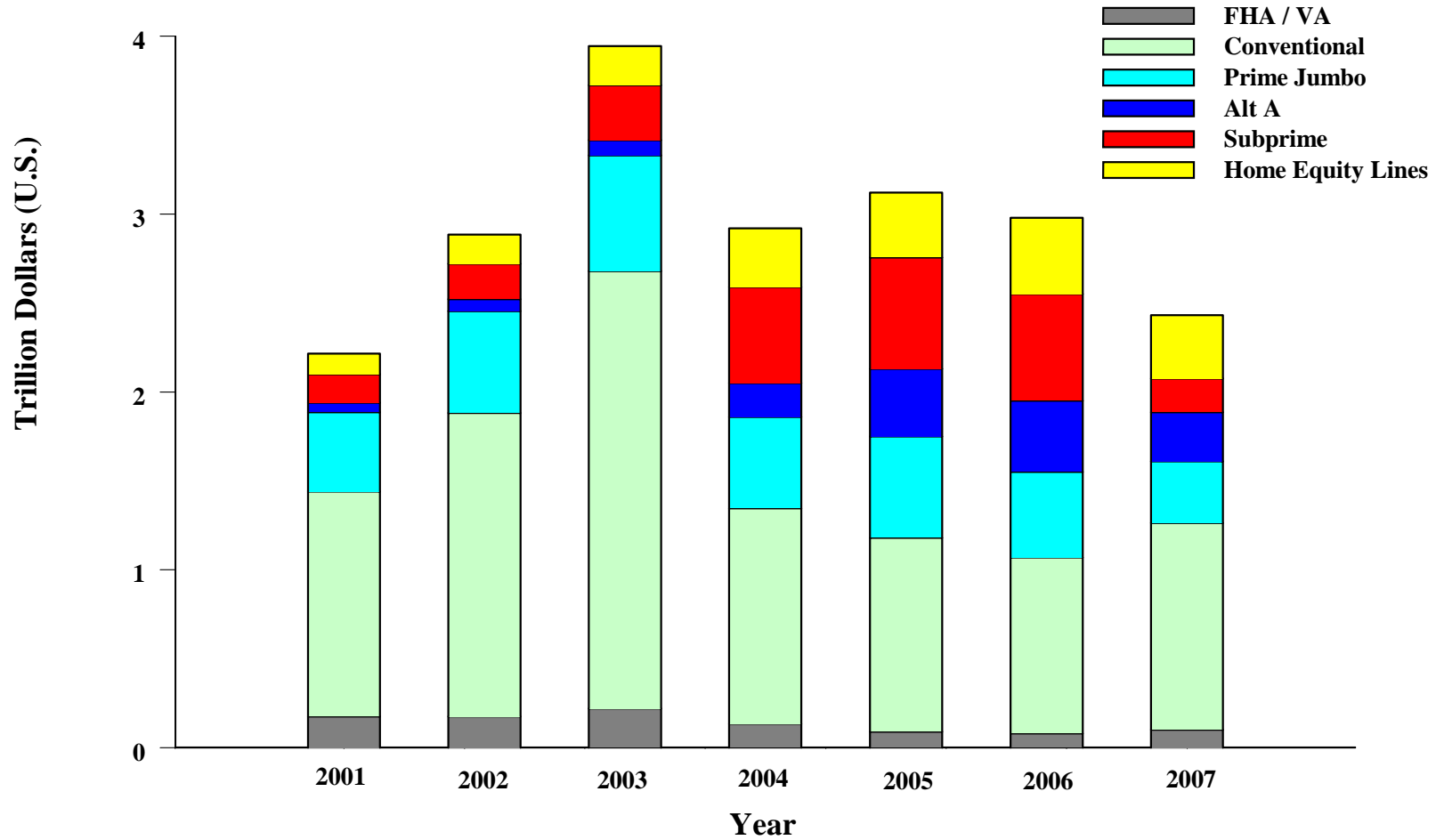
*January 2000 through July 2008*



Sources: OFHEO and Haver

# U.S. Mortgage Originations by Type

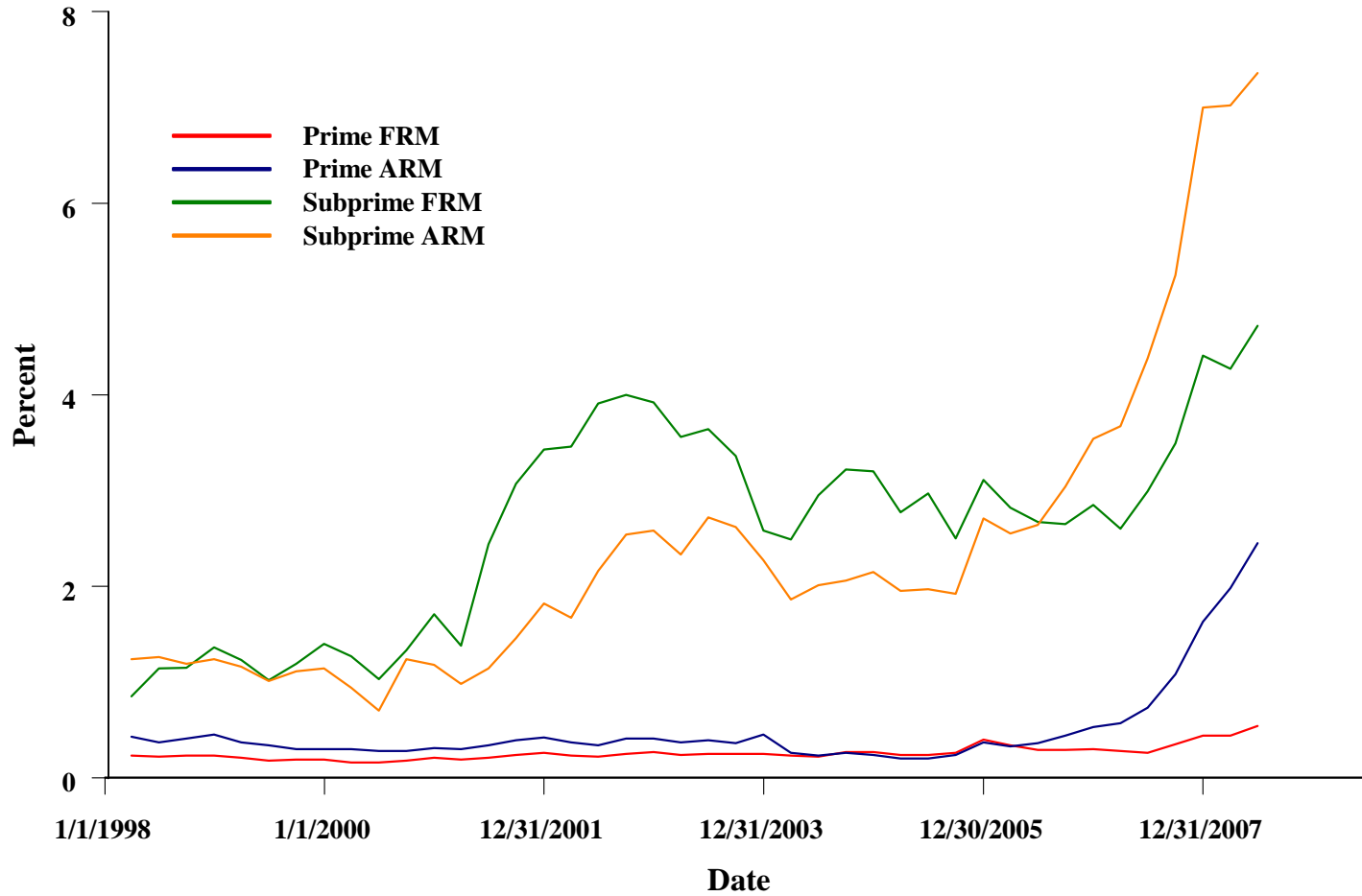
*2001 through 2007*



Source: Inside Mortgage Finance

# U.S. Mortgage Delinquencies by Loan Type

*First Quarter 1998 through Second Quarter 2008*

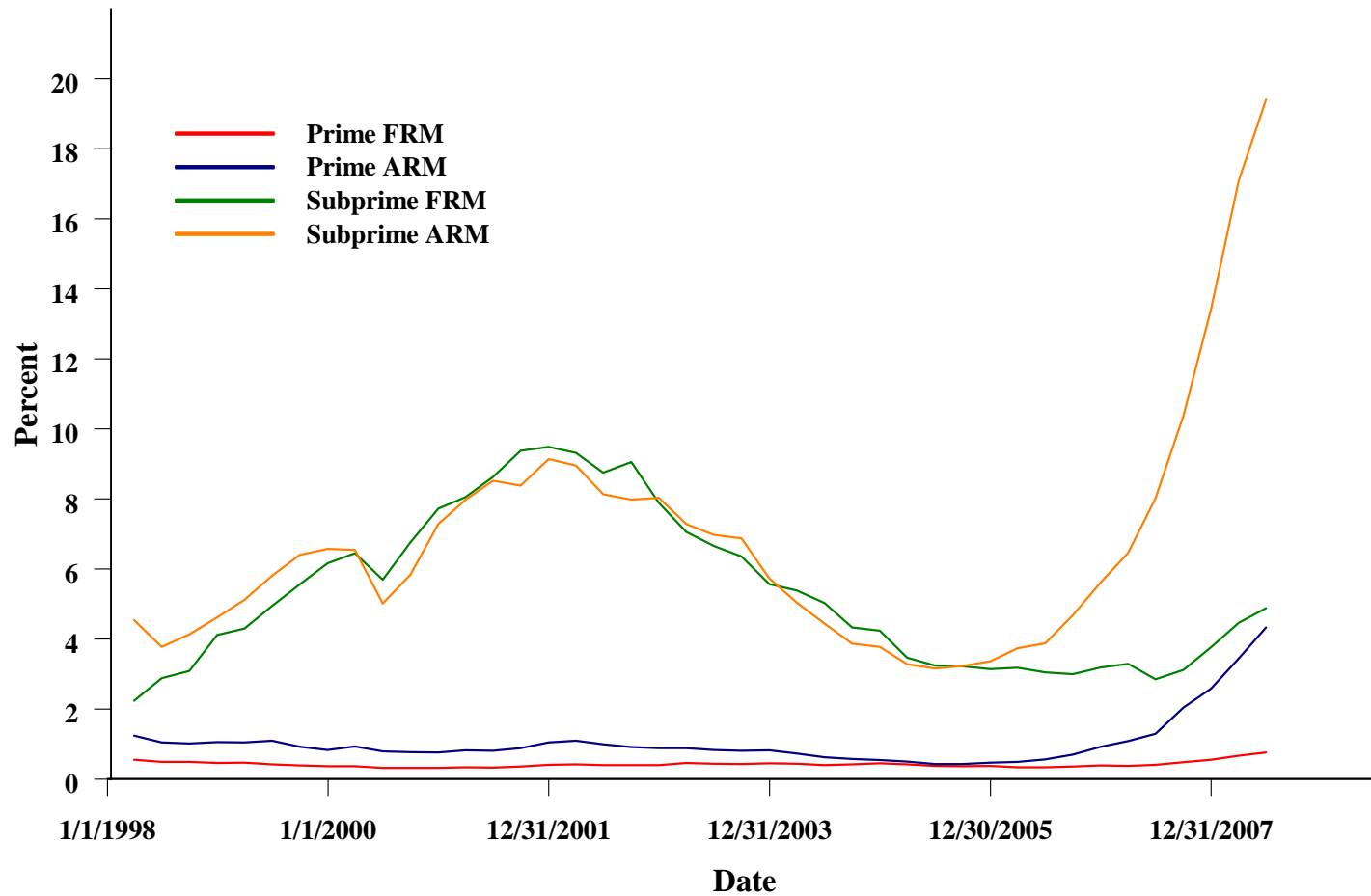


Note: Delinquent 90 days or more

Source: Mortgage Bankers Association

# U.S. Mortgage Foreclosure Inventories by Loan Type

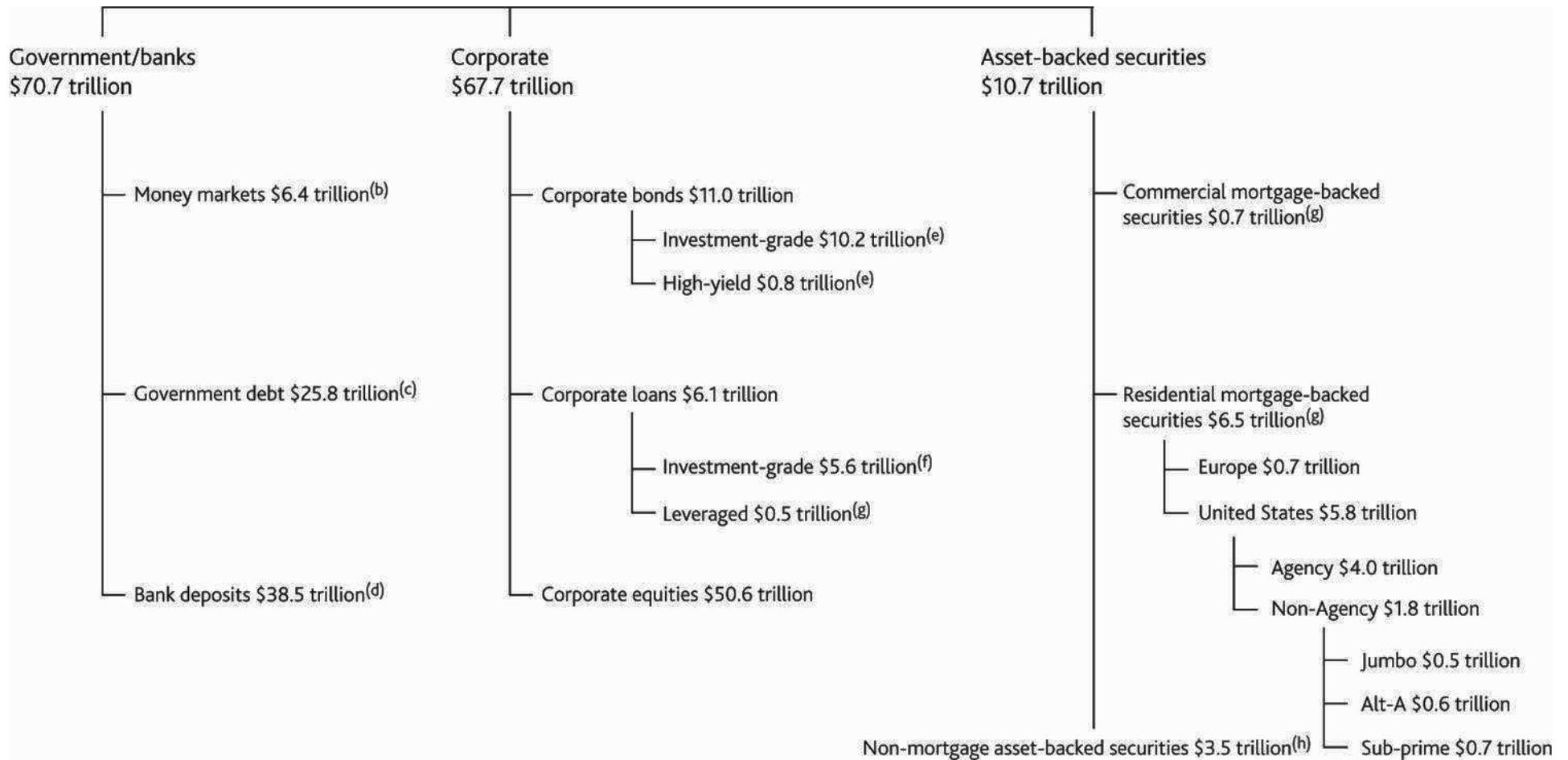
*First Quarter 1998 through Second Quarter 2008*



Note: Foreclosure Inventories

Source: Mortgage Bankers Association

# Size of Financial Markets



Source: Bank of England Stability Report, 10/2007

# Story

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- A tiny part of securities markets has put asset markets around the world in a state of turmoil?
- How can that be?
  - Partly true
    - Disruptions in Norway, Euro area, and U.K. besides U.S.

# Securitization of Mortgages

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- Residential Mortgage Backed Securities (RMBS)
  - Mortgages are pooled together and sold on the open market
    - Agency securities
    - Others
- Collateralized debt obligations (CDO)
  - Credit instruments are pooled together (e.g. mortgages), payments are divided into tranches and sold on the open market
  - A key difference is the division into tranches

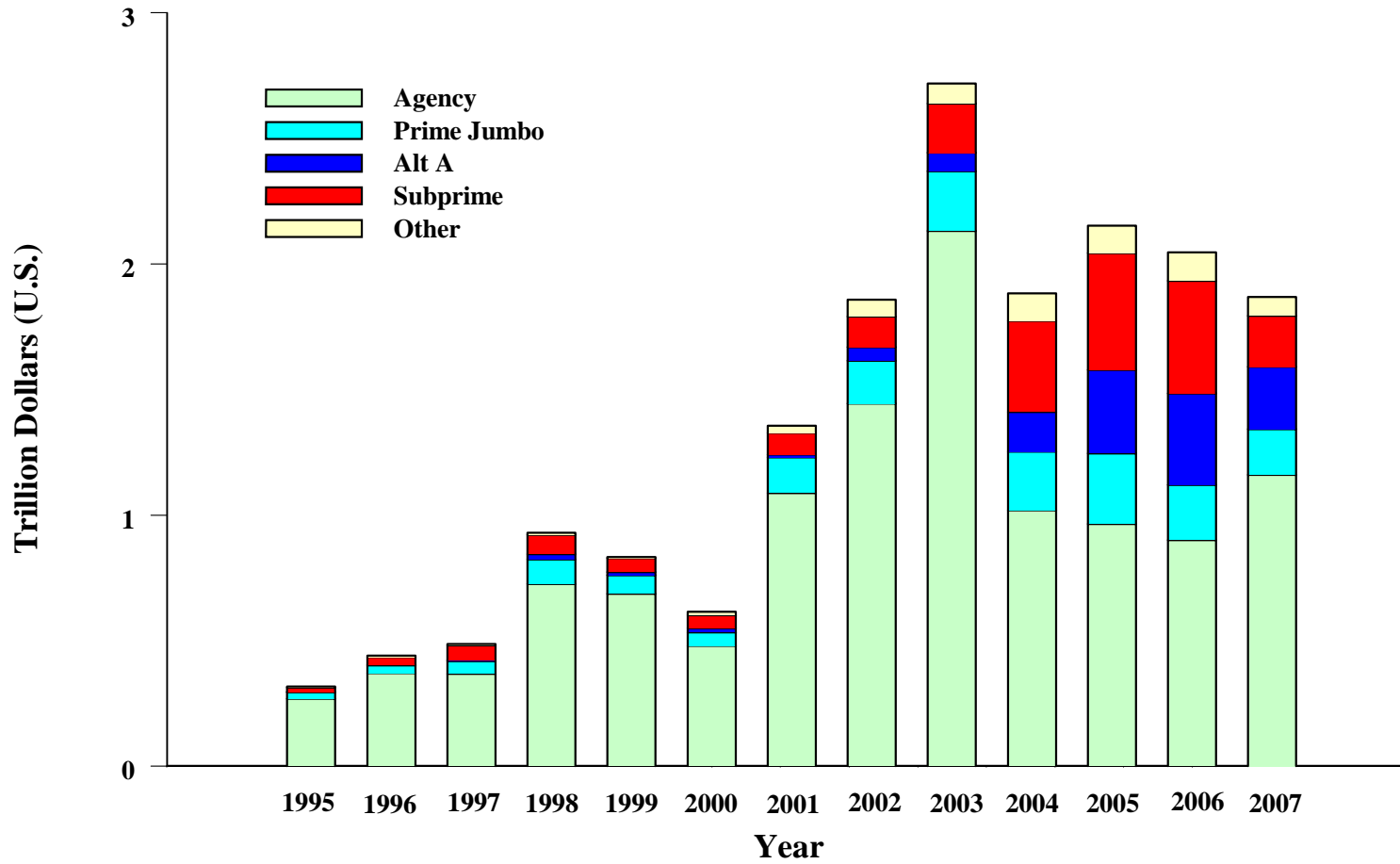
# Tranches on Securities

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- Instead of one security (RMBS), several securities are issued (CDO)
  - Tranches
    - AAA (rated)
    - Mezzanine tranches (rated AA to BBB-)
    - Equity tranches (unrated)
  - Priority of paying determined by tranche
- Priority on a pool of mortgages, some paying, some not
  - Simple example (actually more involved)
    - Suppose that all mortgages paying but one
    - People who own AAA part get paid everything
    - People who own mezzanine part get paid everything
    - People who own equity part get paid everything except mortgage payment not made

# U.S. Residential Mortgage-Backed Securities Issuance

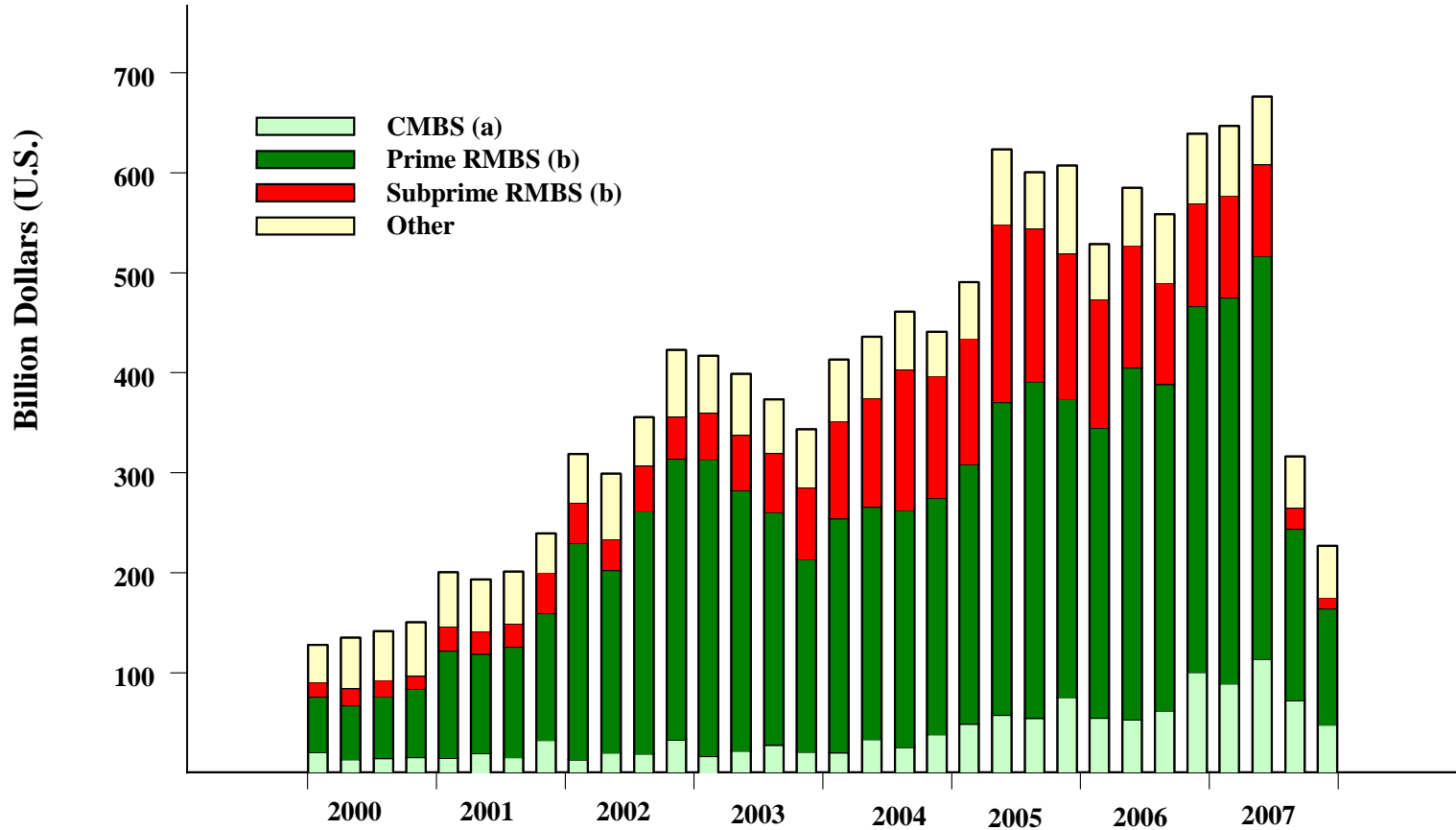
*1995 through 2007*



Source: Inside Mortgage Finance

# Global Issuance of Asset-backed Securities

*First Quarter 2000 through Fourth Quarter 2007*



Source: Dealogic and Bank of England Financial Stability Report, April 2008

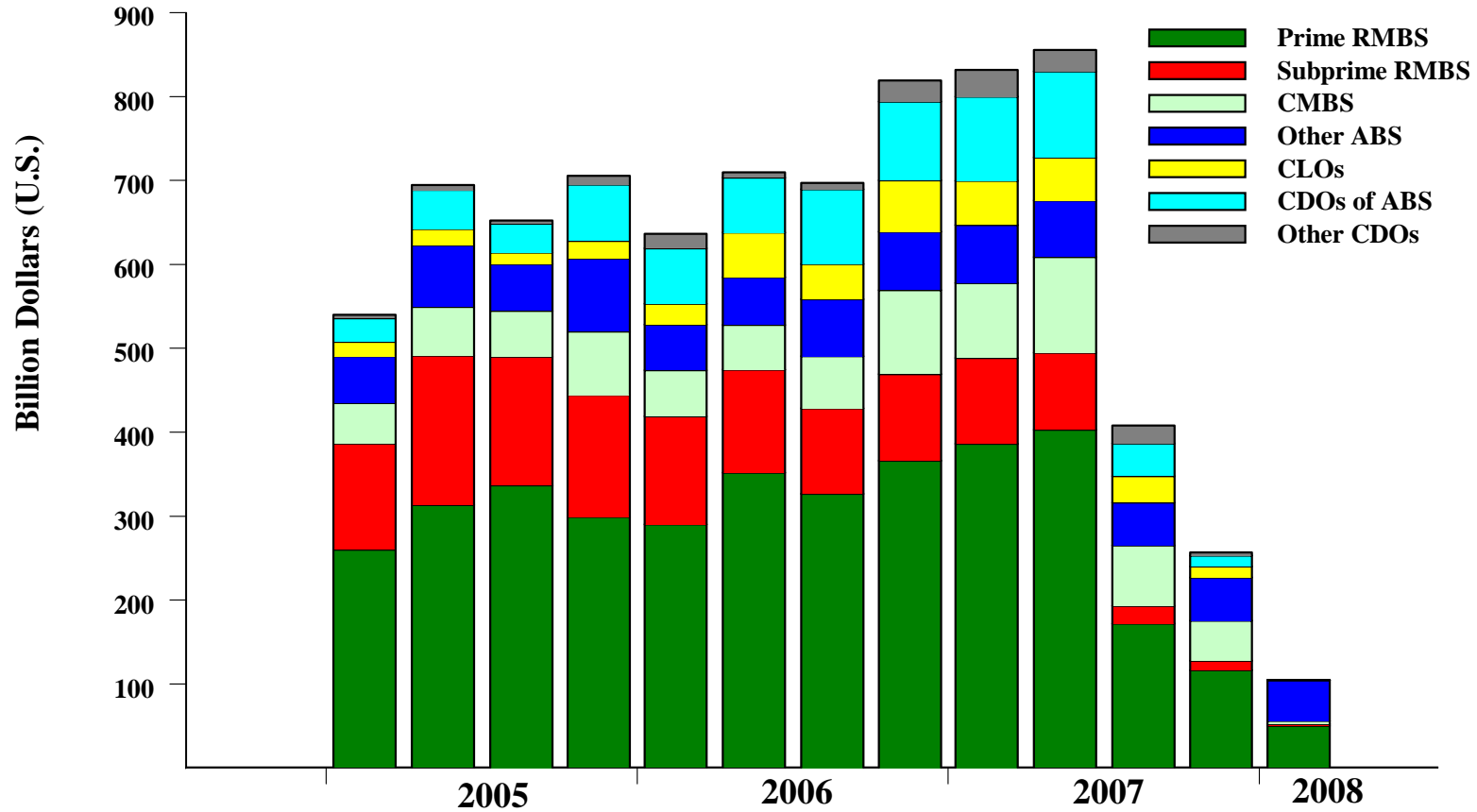
(a) Commercial mortgage-backed securities

(b) Residential mortgage-backed securities

(c) 'Other' includes auto, credit card and student loan ABS

# Global Issuance of Asset-Backed Securities and Collateralised Debt Obligations

*First Quarter 2005 through First Quarter 2008*



Source: Dealogic and Sifma

# Market for CDOs

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- CDOs are traded over the counter
  - Not on an organized exchange such as NYSE
  - Trade through brokers and dealers

# CDOs

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- CDOs are not identical
  - Standardized securities
    - The same provisions
    - The same developments determine the income received by the owner
    - Income received by each share is identical
  - Residential CDOs
    - Mortgage loans for houses
      - Each loan is likely to have idiosyncratic characteristics
    - Income received by AAA CDO owners not necessarily the same
      - Same for a particular deal (SPV)

# Idiosyncratic Securities

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- How are idiosyncrasies reduced in CDOs?
  - Portfolio of loans
  - Value tranches
    - AAA
    - Mezzanine
    - Equity
    - Idiosyncratic part most important for equity tranche

# Securities and “Risk Sharing”

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- CDOs were purchased by entities all over the world
- AAA rating made them seem like a fine purchase
  - AAA CDO is not a AAA corporate bond
    - CDO is based on a portfolio of loans
    - Behavior of cash flows in default is different
  - Ratings were conditioned on rising house prices

# Two Developments Created Problems

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- Rising delinquency rate due to problematic mortgages
- Falling home prices increase probability of default
  - Loan-to-value matters
    - Date of issuance of mortgage
  - Location matters
  - Maybe issuer matters

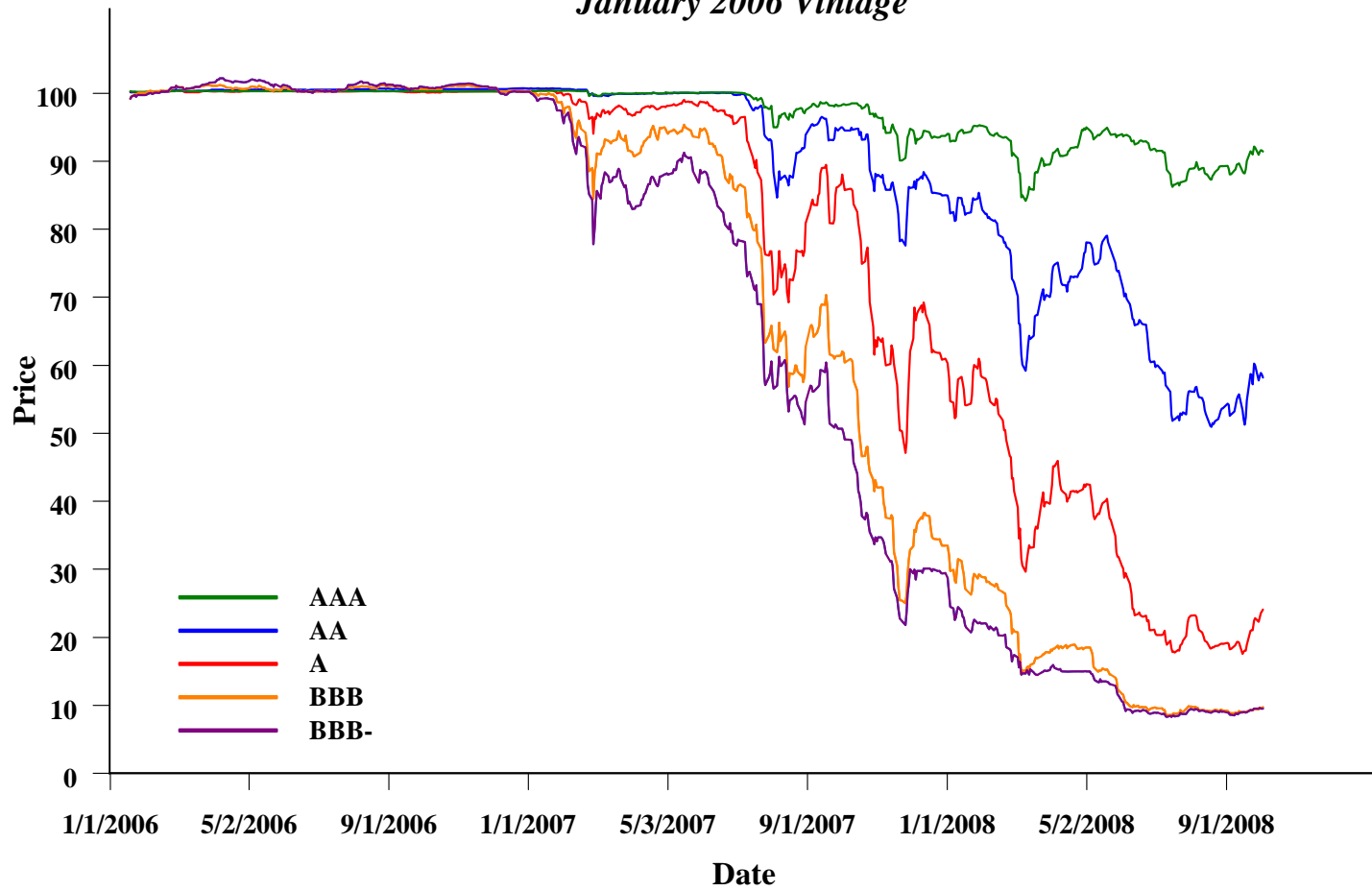
# Implications of Higher Probability of Default

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- Characteristics of specific loans become more important
  - Securities become more difficult to value
  - Tends to lower price
- Volume in over-the-counter market decreases
  - Tends to lower price
- Correlation risk
  - By construction, portfolio of loans reduces idiosyncratic risk
  - Losses on lower-rated tranches associated with losses on higher-rated tranches
  - Losses may have a higher correlation across tranches than perceived by buyers of higher-rated tranches
  - Losses can be more highly correlated with a large common shock

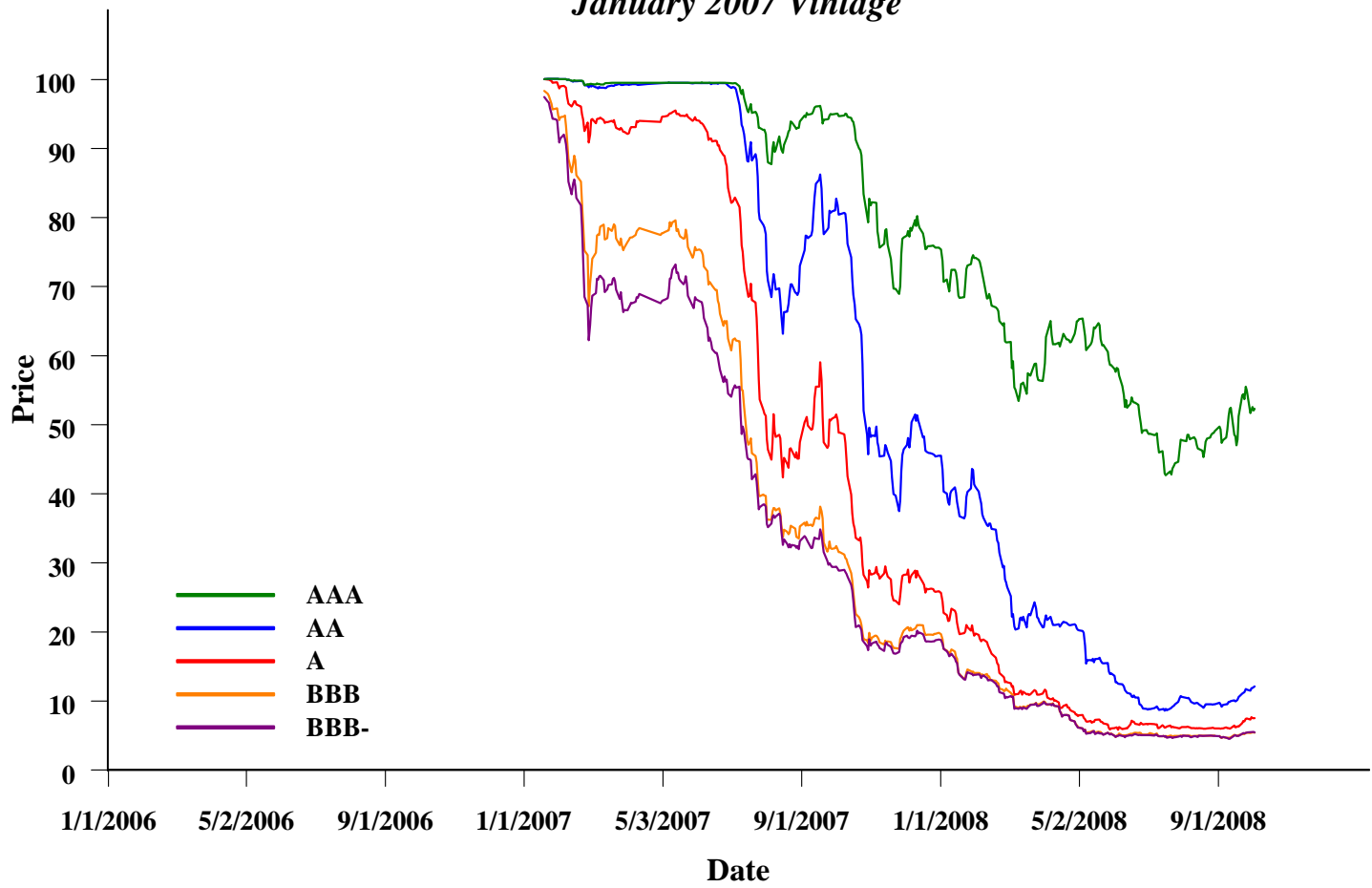
# Index of CDO Prices

*January 2006 Vintage*

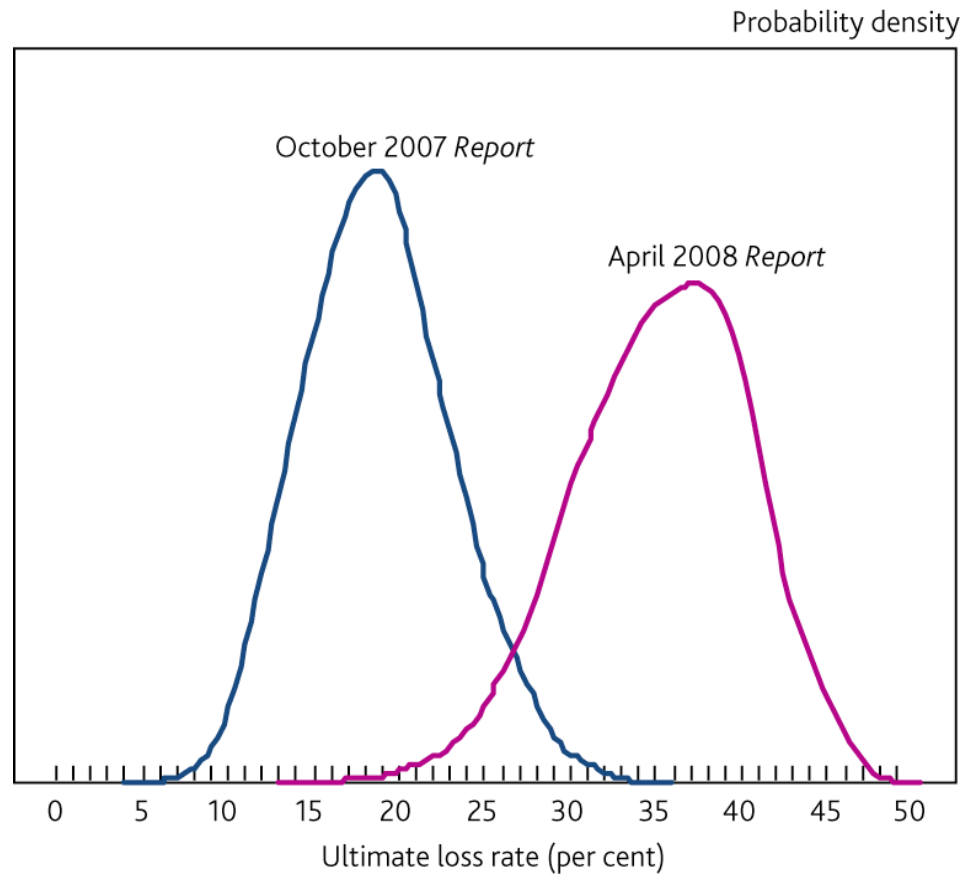


# Index of CDO Prices

*January 2007 Vintage*

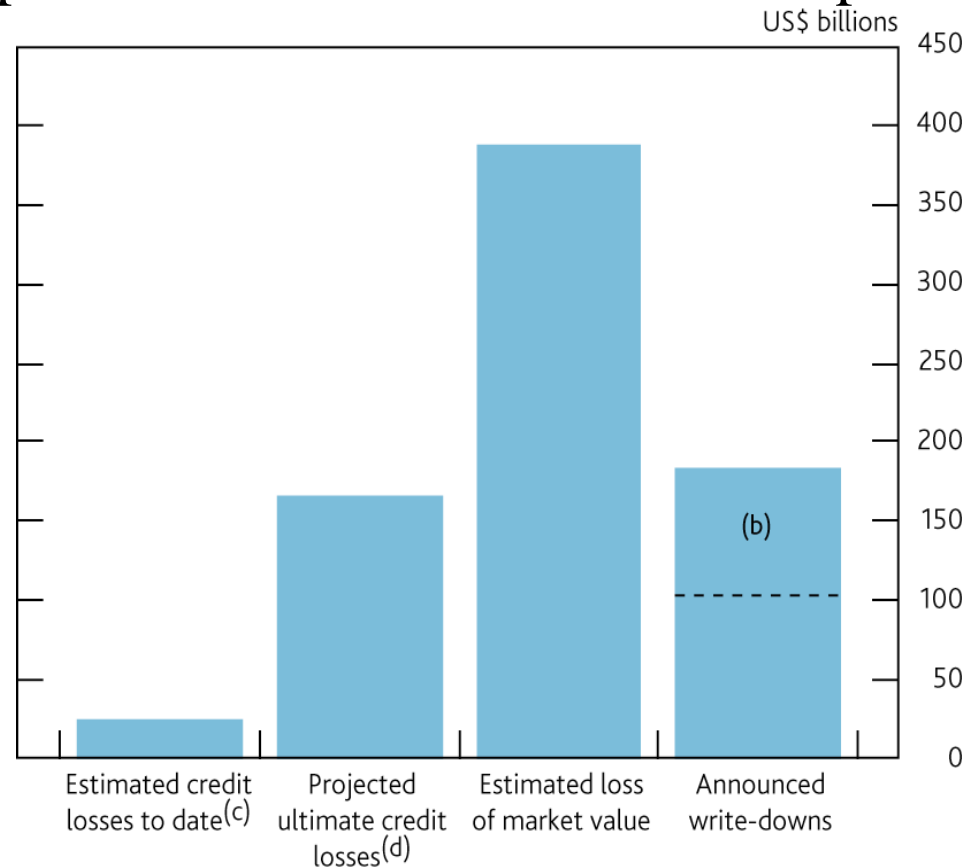


# Market-implied Expectations of Ultimate Loss Rates on U.S. Subprime Mortgages



Source: Bank of England calculations using data from JPMorgan Chase & Co.

# Estimated Losses on Subprime Asset-backed Securities April 2008



Sources: Banks' financial statements, Bank of America, BlackRock, Dealogic, JPMorgan Chase & Co., Moody's Investors Service, Standard and Poor's and Bank of England calculations.

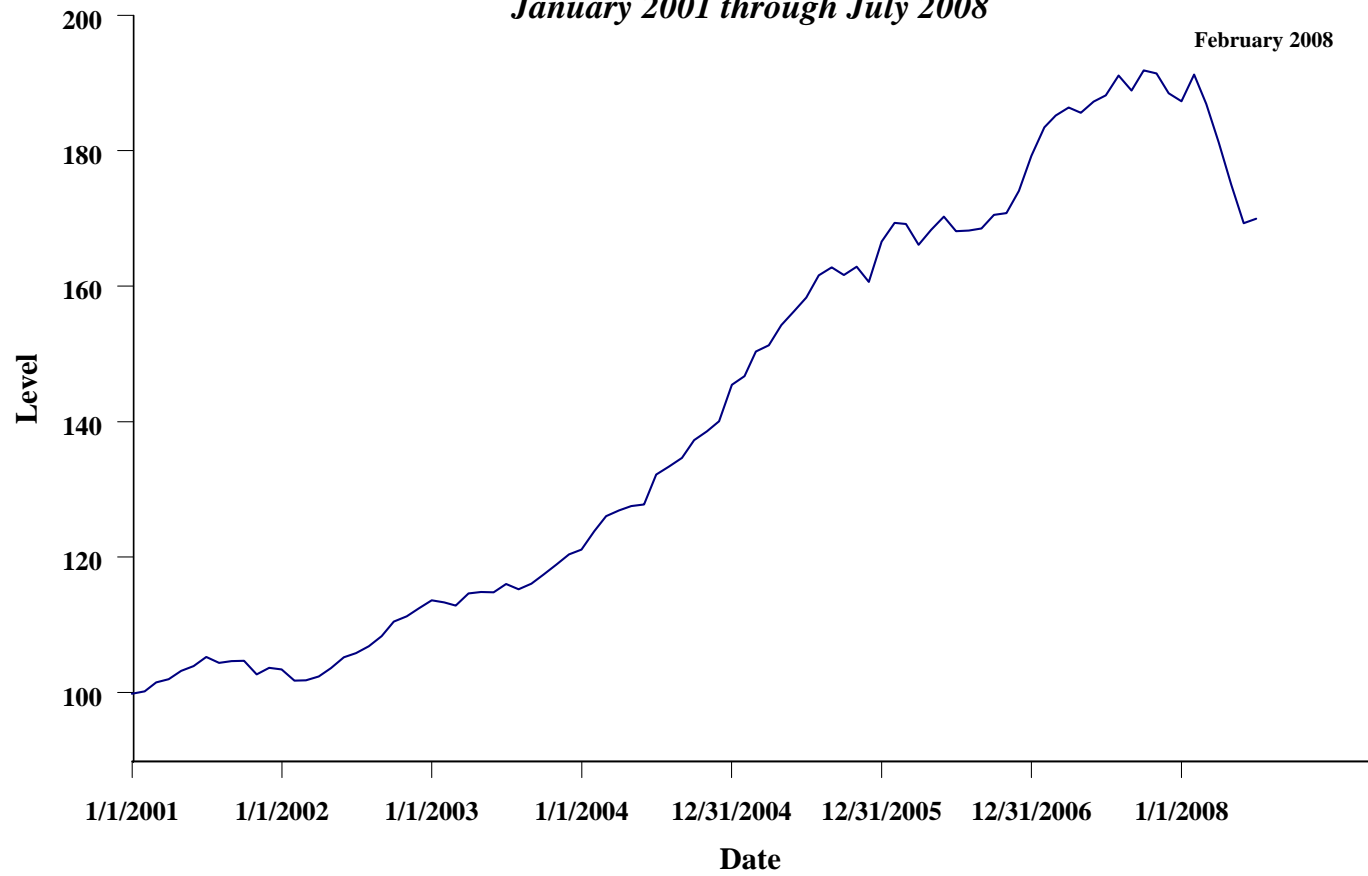
(b) Area below dotted line shows net write-downs by major UK banks and LCFIs since the start of 2007 to 22 April 2008, while total height of bar shows an S&P estimate (published on 13 March 2008) of write-downs by all investors.

(c) This estimate is derived from data on actual delinquency rates on outstanding mortgages by vintage and an assumption about the transition from delinquency to default

(d) This estimate is derived in the same way as for estimated credit losses, but assuming that serious delinquency rates on different vintages continue to rise at their average rate to date until the mortgages are four years old, when they are assumed to be plateau.

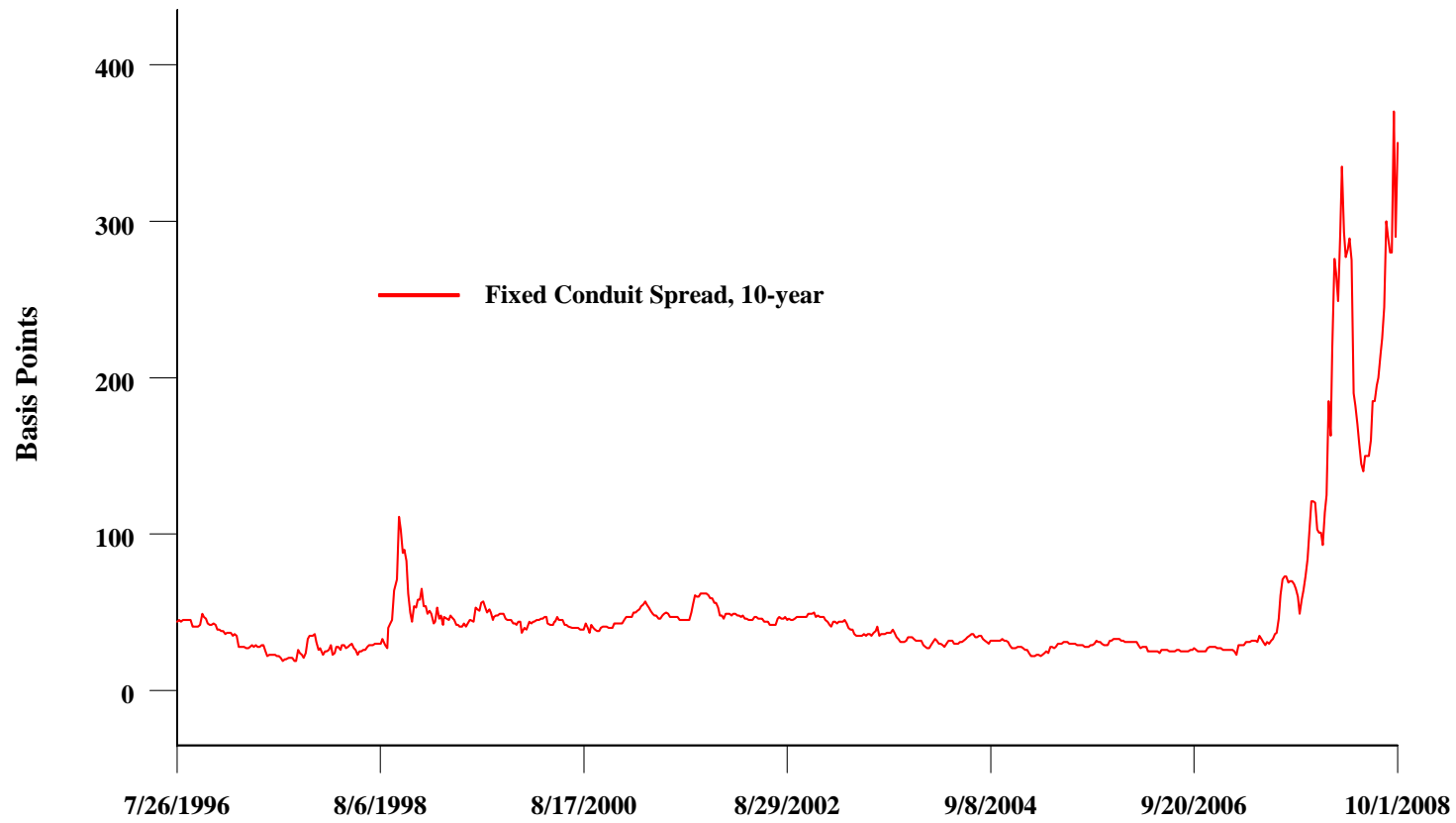
# Moody's / REAL National Commercial Property Price Index

*January 2001 through July 2008*



Source: MIT Center for Real Estate

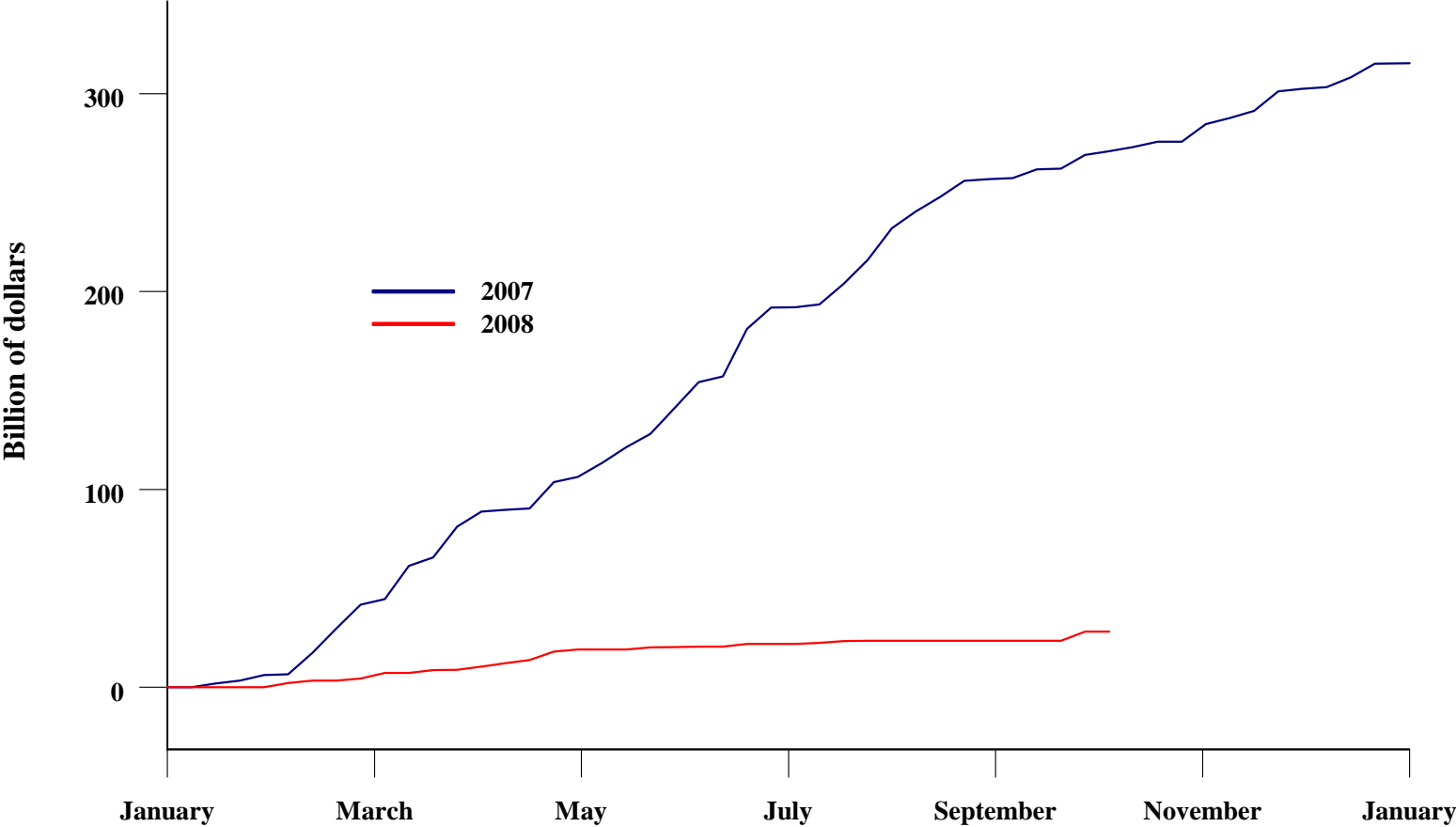
### CMBS AAA Spread over Swaps



Source: Commercial Mortgage Alert / Morgan Stanley

# Worldwide CMBS Issuance

2007 and 2008



Source: Commercial Mortgage Alert

# Failures of Financial Institutions

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- Smaller banks
- Bear Sterns
- Fannie Mae and Freddie Mac
- Washington Mutual
- Lehman Brothers
- AIG
- Wachovia
- More to follow

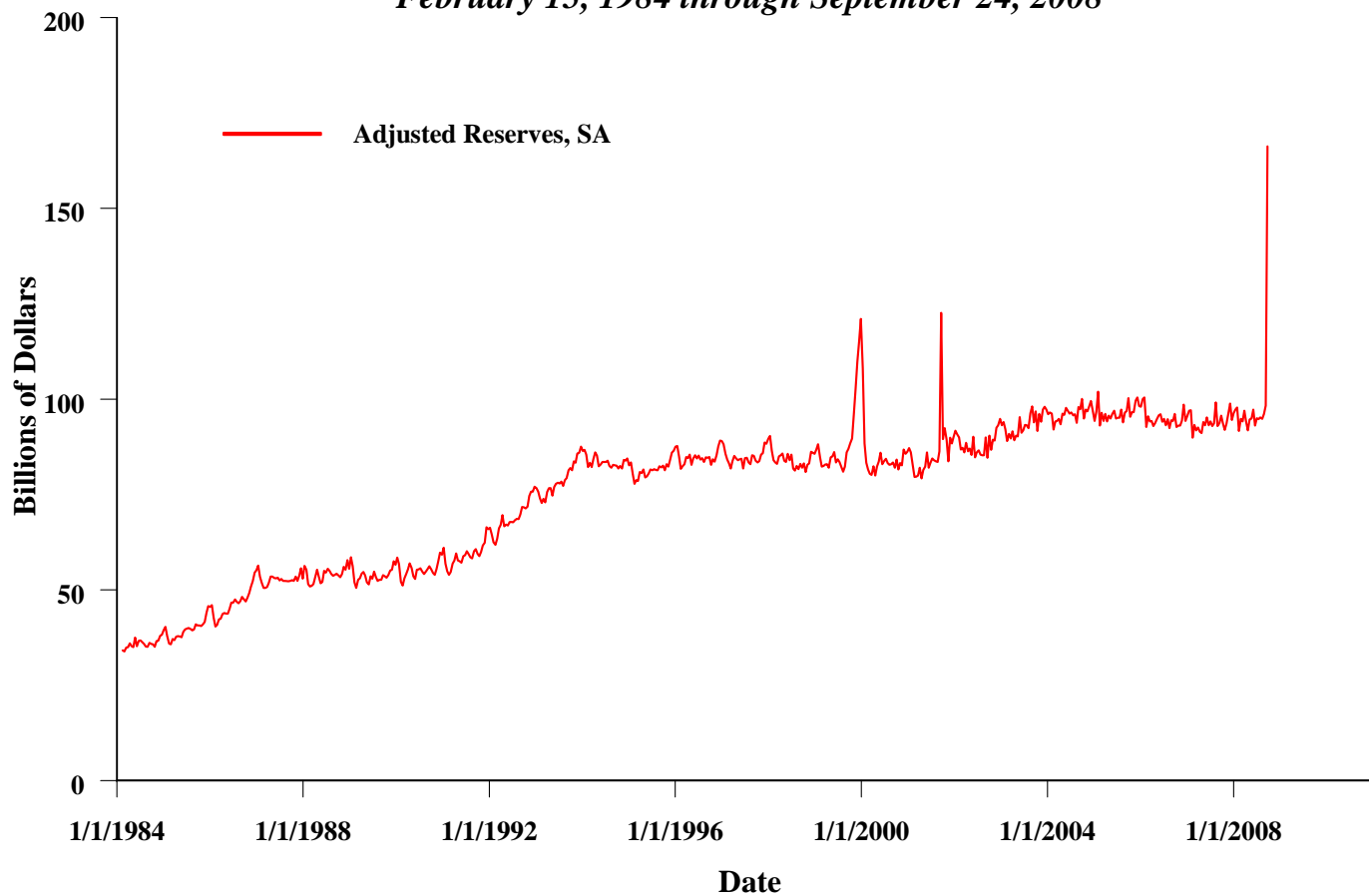
# Policy Measures

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- Lower Fed Funds rate and borrowing rate
- Lending Treasury securities in exchange for a broad range of assets
- Providing investment banks access to Federal Reserve funds

## Adjusted Reserves

*February 15, 1984 through September 24, 2008*



Source: Federal Reserve Bank of St. Louis

# Government Intervention in Particular Markets

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- Mortgages
- Fannie Mae and Freddie Mac
- Bear Stearns, Lehman, Wachovia
- Economic Recovery Act

# Foreign Governments

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- Foreign central banks have been borrowing dollars from the Federal Reserve to lend to commercial banks in Europe
  - Probably more important than is commonly realized
  - Foreign commercial banks have substantial losses on U.S. dollar denominated assets such as CDOs
  - Falling real estate prices in Europe
- Resolution of failing firms
- Guarantees of deposits

# Is It Over?

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- Not over
  - Developments as a result of losses will continue
  - More financial problems may surface – “You never know.”
  - U.S. residential construction at a low level
    - Likely to continue for some time
  - Flat to falling house prices

# Financial Difficulties

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- It's the truck you don't see that runs you down
  - Don't take the picture as too serious a metaphor for current developments
- Financial innovation often associated with episodic difficulties
  - Much of history of U.S. financial system
  - U.S. 2001 or so to 2008

