

Corporations Navigating Through Economic Crisis

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ХААН БАНК



SUSTAINABILITY

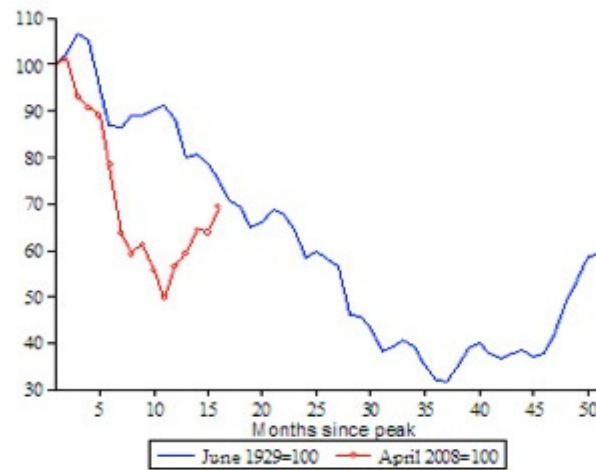
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World stock markets, now vs then



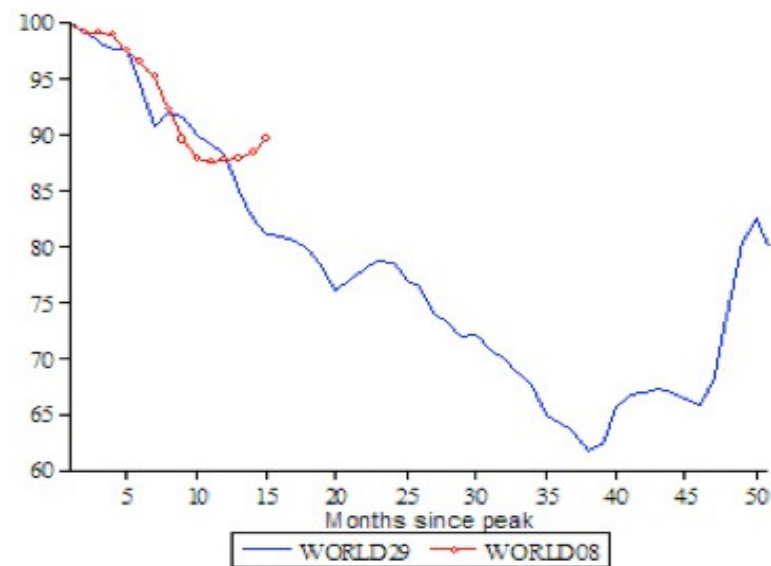
World stock markets, now vs



World industrial production, now vs then



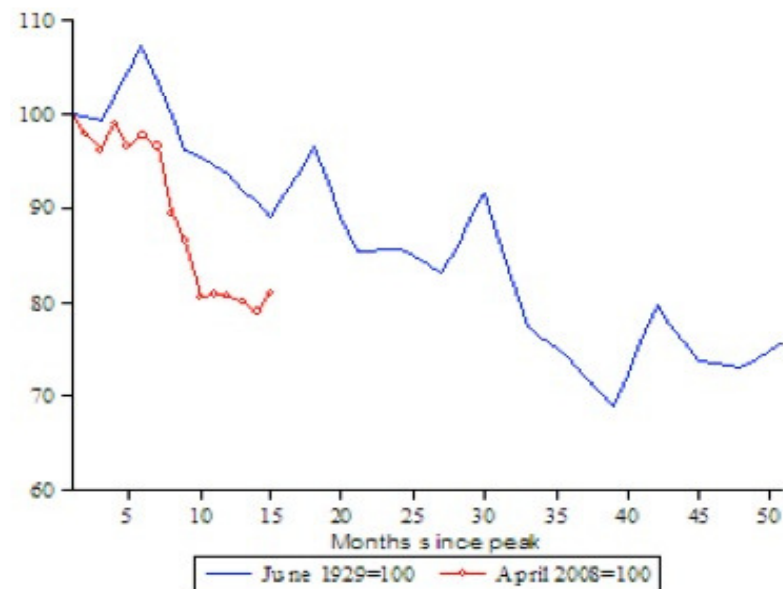
World industrial production, now vs then



Volume of world trade, now vs then



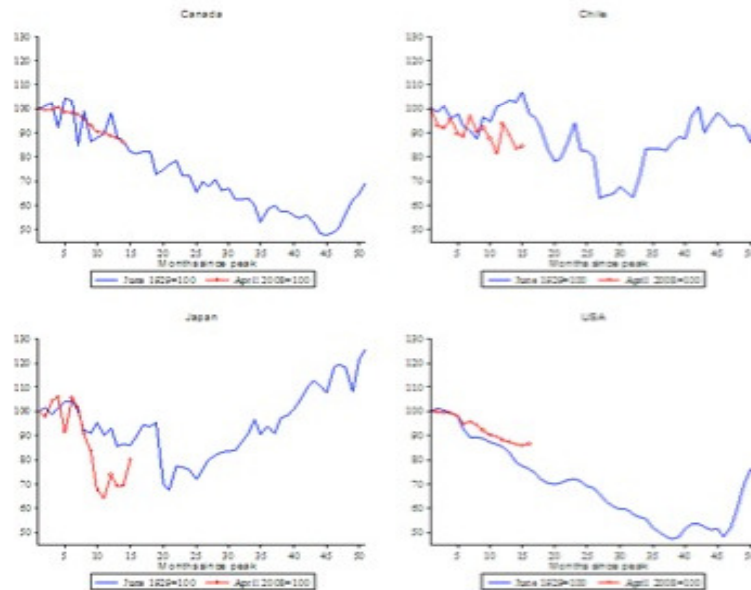
Volume of world trade, now vs then



Industrial output, four non-Europeans, then and now



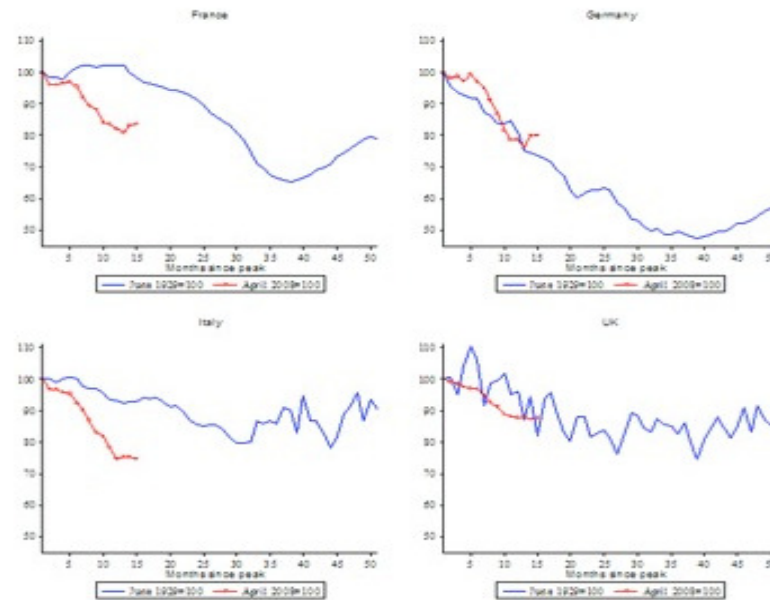
Industrial output, four non-Europeans, then and now



Industrial output, four big Europeans, then and now



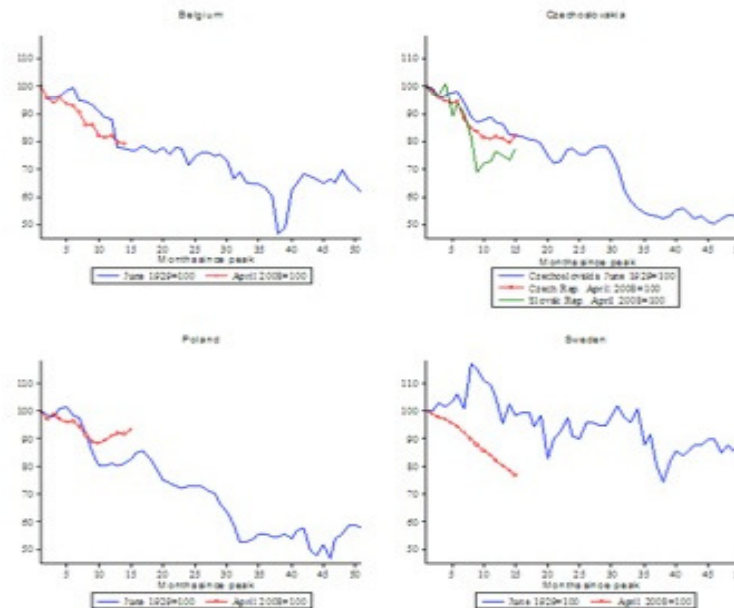
Industrial output, four big Europeans, then and now



Industrial output, four small Europeans, then and now



Industrial output, four small Europeans, then and now



Changing nature of systemic risk with financial innovation



- In the old times (1960s-1980s): banks held the credit risk of their lending on balance sheet. “Originate and hold” model
- Then when many bad loans/mortgage were made defaults would rise, a credit crunch would ensue and then a recession (S&L crisis in late 1980s/early 1990s)
- New model since 1980s: securitization (“originate and distribute” model). Banks not holding the credit risk but transferring to others.
- Argument made that systemic risk should become lower as credit risk is spread out of the banks to capital markets and investors, domestic and abroad, as you slice and dice the risk
- Problem: systemic risk turned out to be now as high as in the past: massive domestic and global financial contagion and now risk of a hard landing of the economy.
- So what went wrong?

What went wrong?



- It was not just a sub-prime mortgage mess
- Same reckless practices as in sub-prime occurred in near prime, prime, home equity loans, piggyback loans, etc.
- Reckless practices such as:
 - No down payment
 - No verification of income/assets/jobs (LIAR loans) Interest rate only mortgages
 - Negative amortization
 - Teaser rates
 - Hybrid ARMs
- 60% of all mortgage origination in 2005-2007 had these toxic reckless characteristics

Why reckless lending?



- Why reckless lending?
- 1.Regulators/supervisors were literally asleep at the wheel:
- They were cheerleading every form of financial innovation
- They allowed and supported reckless lending practices in mortgages
- Laissez-faire ideology of free market fundamentalism
- 2.Securitization food chain led to wrong incentives and poor monitoring of lending

Securitization food chain led to wrong incentives & distortions



- Securitization food chain: Everyone now gets a fee (not investment income) and does not hold the credit risk (wrong set of incentives as there is little incentive to monitor the quality of the loans):
- Mortgage broker maximizing its income by maximizing the volume of approved mortgage
- Mortgage appraiser having an incentive to inflate the value of the home
- Mortgage originator bank transforming the mortgages into RMBS and getting fat fees
- I-Bank turning RMBS into CDO tranches (and into CDOs of CDOs, and CDO cubed) and getting fat fees
- Credit Rating Agency rating or misrating RMBS and CDOs and being paid by the issuers. Conflict of interest.

Securitization food chain led to failure of market discipline



- Finally no market discipline as final investors buying the toxic waste (RMBS, CDOs) were greedy and clueless about new, complex, exotic instruments that were illiquid, priced to model rather than to market and mis-rated by rating agencies.
- How can anyone rate and price correctly a CDO of CDOs of CDOs (CDO-cubed)?
- Problems in the securitization chain: information, asymmetries, adverse selection, moral hazard.

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Эрсдэлийн Удирдлагын
Форум



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