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Program on Financial Stability

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FCIC June Retreat - List of Big Picture Ideas

United States: Financial Crisis Inquiry Commission (FCIC)

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1. **Too much liquidity chasing higher returns** (John)

- Money flowing into the system
- Caused “irrational” behavior
- Cheap money – huge bets and new higher levels of risk taking
- Interest rates (particularly long-term)

2. **Great Moderation** (Doug)

- Failure of pricing risk
- Greenspan put
- The ultimate moral hazard
- Contributed to regulatory environment
- Bad business cycles became a distant memory

3. **Why were warning signals ignored?** (Bob)

- No entities focusing on signals (not rating agencies)
- Key players want to ignore

- Early warning entities not capable (accounting, profession, rating agencies...)
- Example of signal: FBI warning in 2004

4. Failure of corporate financial risk management and governance in the financial sector (John)

- Outsized compensation packages – tied to equity markets that were soaring
- Outdated models with new risk
- Long-term consequences not collaborated to short-term risks

5. Loss of consequences for behavior (Byron)

- Lack of capital
- No “skin in the game”
- Individuals borrowed too much

6. Leverage (Heather)

- At every level: household, corporate, systemic

7. Hyper-sensitive short-term liquidity model (Keith)

8. Housing and commercial real estate bubble (Doug)

- Should check other assets to see if there is parallel behavior

9. Housing (Bill)

- Broadly defined
- Explosion of subprime lending
 - Including predatory lending and fraud

10. GSEs (Keith)

11. Failure of regulation/regulatory reform (Brooksley)

- Government failed to prevent excesses
- Failure to regulate derivatives and other products
- Failure to regulate shadow banking/markets
- Regulations were insufficient
- Ineffective oversight of markets and institutions

	<u>Markets</u>	<u>Products</u>	<u>Institutions</u>
Regulations	X	X	X
Implementation	X	X	X

- E.g. Glass-Steagall
- Regulatory arbitrage

12. Mark-to-Market Accounting (Peter)

- Writing down mortgage-related assets to current market prices made institutions appear weak
- Spreads the mortgage crisis

13. Over-the-Counter derivatives (Brooksley)

- Lack of federal regulations
- Role of CDS with respect to securitization (by AIG and others on AAA tranches)
- Use in synthetic CDOs
 - Including CDS
- Equally relevant: role of OTC derivatives (millions of contracts with trillions national value)
 - Counterparty risk

- Leverage
- Lack of transparency
- Added to panic and freezing of markets

14. Complex and exotic products (Phil)

- In housing
- In financial markets
- Opacity and leverage
- Betting and amplification

15. Rating Agencies (Bill)

- Gatekeepers
- How did this system evolve?

16. Transparency (Peter)

17. Too big to fail and lack of resolution authority (Keith)

- Policy makers believed they had to step in
- Moral hazard
- System not robust

18. Effectiveness of policy in face of globalization of financial system (Bob)

- Large international institutions in certain countries buying toxic vs. assets
- International regulatory arbitrage
- Coordination of global financial policy
- International contagion
- Global financial markets
- Comparative analysis

19. Scale, size and power of financial sector (Phil)

- By force and design?
- Outsized effect of financial crisis on economy
- Stop things? Make things happen? Change over time?
- Not a monolith
- Influence of GSEs
- Influence of biggest i-banks and biggest BHCs
 - Look at pivot points

