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SUBPRIME MORTGAGE CRISIS COULD TRIGGER FULL-SCALE DEBT DEFLATION IF HOUSING PRICES CONTINUE TO FALL

New Study from Levy Economics Institute Urges Banking Reforms, Says Current Credit Crunch Differs from Traditional "Minsky" Crisis

ANNANDALE-ON-HUDSON, N.Y.—As policymakers scramble to enact policies geared toward staving off a recession, a new study from The Levy Economics Institute of Bard College suggests that, if housing prices continue to fall, total credit losses from the subprime mortgage crisis to borrowers, creditors, and banks could approach $900 billion. As financial institutions attempt to recoup their losses and tighten credit, American consumers may finally start to retrench, as recent reports are now beginning to indicate. Though the dollar will likely decline further, the offset of increasing exports will not be sufficient to prevent a recession.

In his public policy brief *Minsky's Cushions of Safety: Systemic Risk and the Crisis in the U.S. Subprime Mortgage Market*, Senior Scholar Jan Kregel compares the current crisis to the financial fragility hypothesis put forth by the late economist and Levy Institute scholar Hyman P. Minsky. Kregel argues that, unlike a Minsky crisis, in which Ponzi financing and declining margins of safety lead to increasing financial fragility over time, the current subprime crisis is the result of cushions of safety that have been insufficient from the beginning, primarily in terms of how creditworthiness is assessed (overestimating creditworthiness and mispricing risk) in the new "originate and distribute" financial system and sanctioned by the modernization of financial services. "The current crisis has little to do with the mortgage market (or subprime mortgage market per se), but rather with the basic structure of a financial system that overestimates creditworthiness and underprices risk," Kregel writes. "The bottom line is that the system has been structured to make credit

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too cheap, leading to the assumption of excessive risk in order to provide higher returns."

The banking system that emerged from the 1980s real estate crisis, Kregel contends, was based on the ability of the banks' proprietary trading desks to generate profits and on affiliates to produce fee and commission income. The Gramm-Leach-Bliley Act (1999) and Basel II (2004) further extended the role and activities of banks. Kregel reviews the choices that the new financial system offered, such as the securitization of nonconforming mortgage loans (subprime and Alt-A loans), the creation of "special purpose entities," highly leveraged structured investment vehicles, adjustable rate mortgages, layering, and the transfer of credit risk. He also explains how the credit rating agencies have replaced bank loan officers and credit committees in determining the appropriate margins of safety. This feature represents one of the basic differences between the new banking model and Minsky's original analysis of declining margins of safety. "Those who bear the risk are no longer responsible for evaluating the creditworthiness of borrowers," writes Kregel. "It has been suggested that the agencies' profits are correlated with the overestimation of creditworthiness and the undervaluation of risk. This is a crucial failing in a modern system that is supposed to excel in the distribution of risk and the distribution of risk to those who are best equipped to bear it. But if there is no efficient means of evaluating risk, it cannot be distributed efficiently."

As policymakers consider options for bolstering the economy, Kregel's paper argues that it is vital that there be a reassessment of how the financial system evaluates risk. To highlight his concerns, he suggests that by giving credit rating agencies a major role in evaluating the credit risk of bank assets, implementation of the Basel II risk-based framework may, ironically, provide an inbuilt bias in favor of the underestimation of risk, and thus the undercapitalization of banks, that produces a more fragile financial environment. Furthermore, Kregel questions the ability of the Federal Reserve to ensure stability and control the growth rate of the money supply. He recommends that banking regulators find a way to bring off-balance-sheet (bank) affiliates under the effective control of financial supervisors. "There is nothing that can be done to eliminate the inevitability of financial fragility as Minsky defined it. Fragility can only be damped by systemic policies that Minsky identified as being the purview of Big Government (e.g., a government expenditure or employment plan to support incomes and employment) and a Big Bank (e.g., a central bank willing to support asset prices through the discount window)," Kregel writes. "It is, however, possible to eliminate fragility that emerges as a direct result of flaws in the structure and regulation of the system itself. This is the task that confronts the U.S. financial system today"

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