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Session Notes

### **Understanding the Financial Crisis**

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It's a tall order to advance understanding of the financial crisis, but we can frame the issues. This is a credit crisis. Its origins are in the credit and financial system, not the real economy.

It's the 16th major credit crisis in the last 200 years. All of them have had origins in borrowed funds used for speculation. Former crises were from third world debt, leverage buy-out and other sources, and they occurred within a regulated banking system. The current crisis had its major origin in sub-prime home loans; it occurred within an unregulated banking system.

The nature of credit is that it's easy to make a loan if you have money, and easy to get someone to take the money. If you underprice, it's easy to be a super salesman. But too much of a good thing can lead to devastating consequences.

When there's a dramatic repricing of the stock and debit/credit market, a crisis of confidence in financial institutions occurs, leading to a real capital squeeze.

The credit crisis became an economic crisis, with layoffs, job losses and loss of economic output. From what we can measure, this crisis is as bad as the ones in the 1970s and 1980s, though not as bad as the lost decade in Japan. What is unprecedented is the size and speed of the monetary response by the federal government. This response is a good thing.

The crisis is clearly global and covers all sectors.

There's much more credit outside the banking system than inside. Borrowers and lenders are brought together through bonds, paper, etc. The failures are market failures rather than bank failures. Authorities are worried about markets, not just institutions. Institutions are too interconnected to fail.

The crisis became a retail crisis. Assets are in the hands of investors, who had no way to restructure loans.

Were there failures of management? Lenders lent to people without the cash flow to pay back the loan. They didn't see the big picture of the mortgage market. Security houses and investment banks facilitated the crisis because they allowed shadow banking that made these loans work. Law and politics also played a part, as there was political momentum for home ownership.

What can we do about this? In the short term, we can restore trust and confidence. We can provide insurance in institutions. The federal government is using the balance

sheet to buy commercial paper so credit markets function. When value starts to restore confidence, people will start to buy financial assets.

We can also put together a stimulus plan to get the economy going again. Households aren't spending; businesses aren't spending—only the government can spend. There's been a dramatic change in savings rates in households and a huge slowdown in spending.

In the long term, we need to look at regulation. Finance needs regulation: Irresponsible competitors always gain market share. The monetary policy in the future will have to keep an eye on imbalances.

From 1947 to 1980, debt-to-GDP was 150 percent. From 1980 to today, it's between 150 and 350 percent. Growth in activity is sustained through credit—it can't keep growing faster than the economy.

In addition, we need to see more international cooperation: Countries must work together.

Darrell Duffie

If we go back to the epicenter of the crisis and see where it started, we find that securitized products are at the center. Investments are done in securities markets: It's expensive for banks to sit on cash flow from loans; they want to borrow on their loans. The bank must hold back the last available cash flows because that's a signal to the market that they stand behind their deal, that they'll suffer the losses.

Investors went after securitized products with varying quality and risk. Demand for securitized products made banks more likely to grant cheap mortgages. The scope has widened dramatically, as banks don't have enough capital to lend. We now find ourselves in a deep recession like every other country.

Questions and Answers

Q: Why it is so difficult to understand what has happened to this money? Why can't they find the toxic waste?

A: The money is in so many different hands. Millions of hands, and people don't have to report.

Q: Are we on the brink of a commercial real estate crisis?

A: An awful lot of it was financed by commercial-backed mortgage securities. The federal government may buy some of that.

Q: Why did it hit everywhere?

A: Asian economies depended on a constant stream of income from us. Anyone who's relying on borrowed funds is impacted. The cost of leveraging is extremely high, so equity collapses.

Q: Who is right, the left or the right?

A: We don't know which will result in more stimulus: tax cuts or spending. So we have both. Hopefully, spending will contribute to something we need anyway. It's amazing how little we know

Q: To what extent is the crisis a result of CEOs' desire for power?

A: The institutions that are really active in originating low-credit mortgages are having the most difficulty (Merrill-Lynch, UBS, Citibank). Was it CEO ego? Bank of America thought its acquisition was a bargain; it wasn't malicious.