
Lessons from the sub-prime crisis

Kevin Davis

Commonwealth Bank Chair of Finance, University of Melbourne

Director, The Melbourne Centre for Financial Studies

www.melbournecentre.com.au

kevin.davis@melbournecentre.com.au

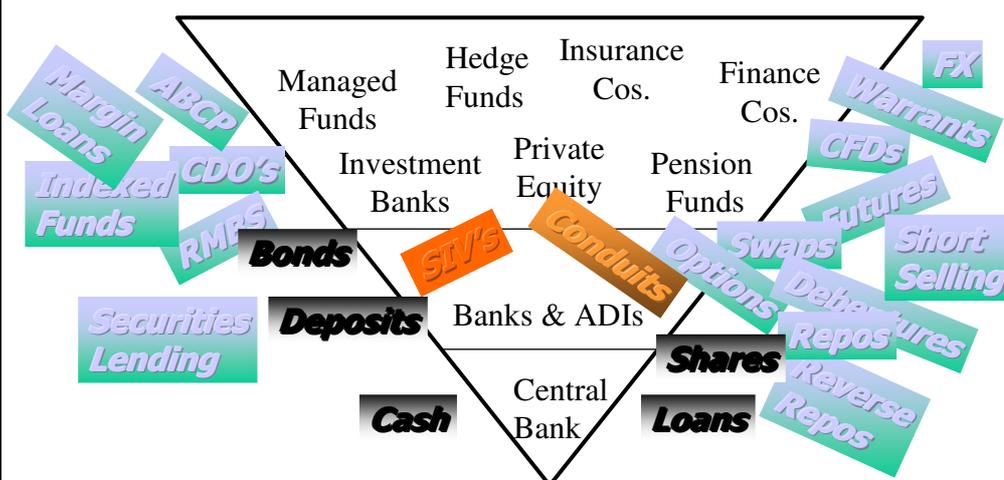
Outline

- Origins of the Crisis
- Features of the Crisis
- Regulatory Responses
- Future Regulatory Responses

Origins of the Crisis

- Financial engineering and financial products
- Liquidity creation and leverage
- “Shadow banking” & risk sharing and spreading
- Inadequate public information

An Increasingly Complex Financial System

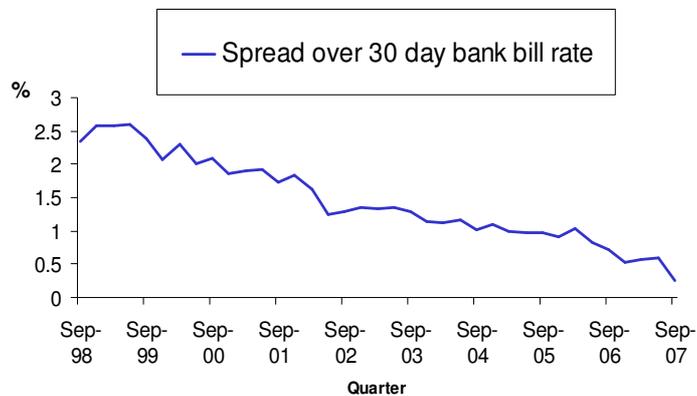


Origins of the Crisis

- Financial engineering and financial products
- Liquidity creation and leverage
- “Shadow banking” & risk sharing and spreading
- Inadequate public information



Easy Credit – An Example Large Business Credit Spreads - Australia

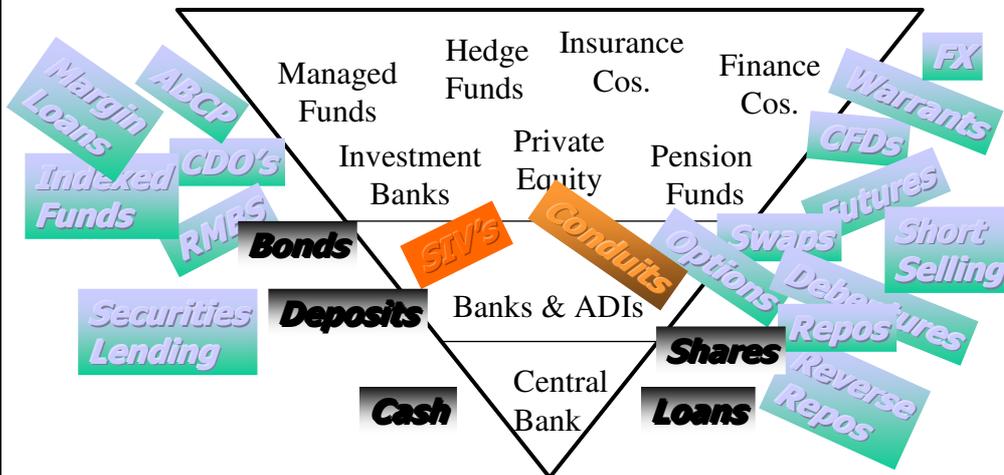


Source: RBA

Origins of the Crisis

- Financial engineering and financial products
- Liquidity creation and leverage
- “Shadow banking” & risk sharing and spreading
- Inadequate public information

An Interdependent Financial System



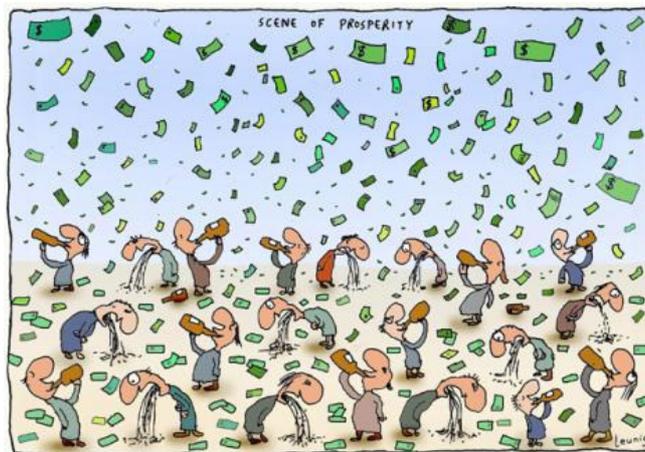
Origins of the Crisis

- Financial engineering and financial products
- Liquidity creation and leverage
- “Shadow banking” & risk sharing and spreading
- Inadequate public information

Public Information



A simple explanation



Features of the Crisis

- Consumer sophistication
- Incentive structures
- Outsourcing due diligence
- Regulatory avoidance
- Inadequate risk management systems
- Excessive liquidity creation

Features of the Crisis

- “Shadow banking sector” importance
- Deposit insurance inadequacy
- “Freezing” of funding and asset liquidity
- Liquidity support facility arrangements
- Inadequacy of risk based capital
- Globalization issues
- “Flight to quality” issues

Regulatory Responses

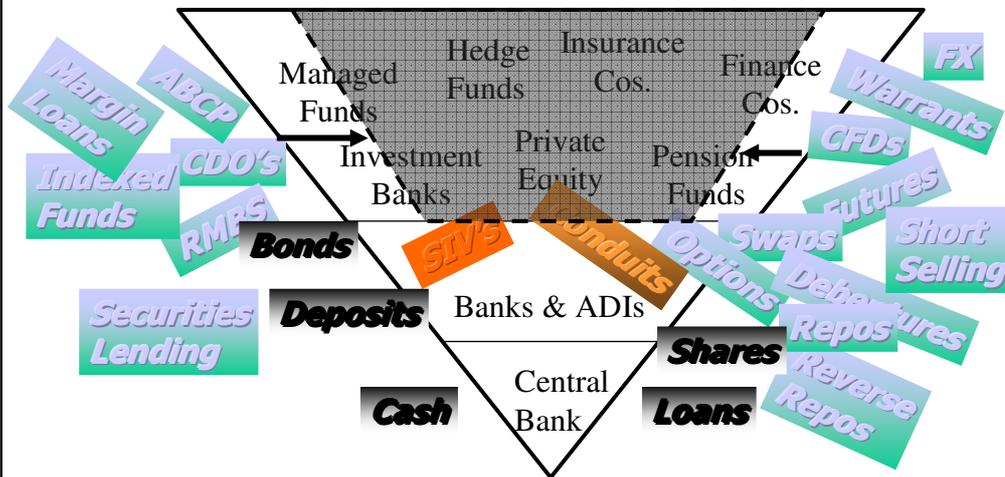
- Protection of national banking systems
- Liquidity Creation/restoration
- Bail Outs
- Temporary regulations



Regulatory Responses

- Protection of national banking systems
- Liquidity Creation/restoration
- Bail Outs
- Temporary regulations

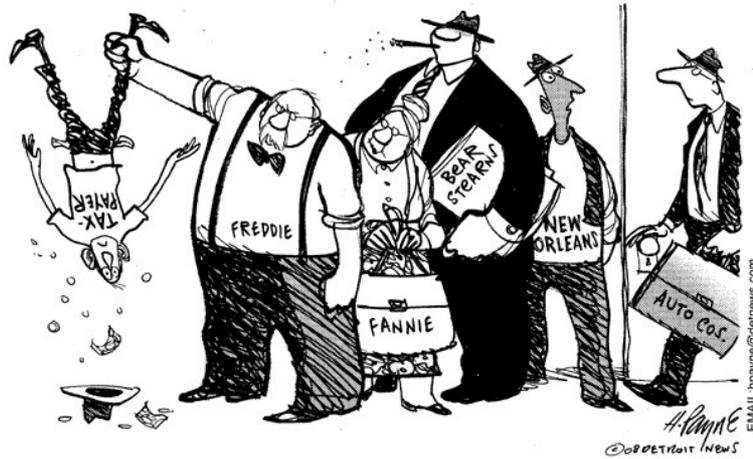
The Flight to Quality Effect



Regulatory Responses

- Protection of national banking systems
- Liquidity Creation/restoration
- Bail Outs
- Temporary regulations

Socializing the losses



"Take a number."

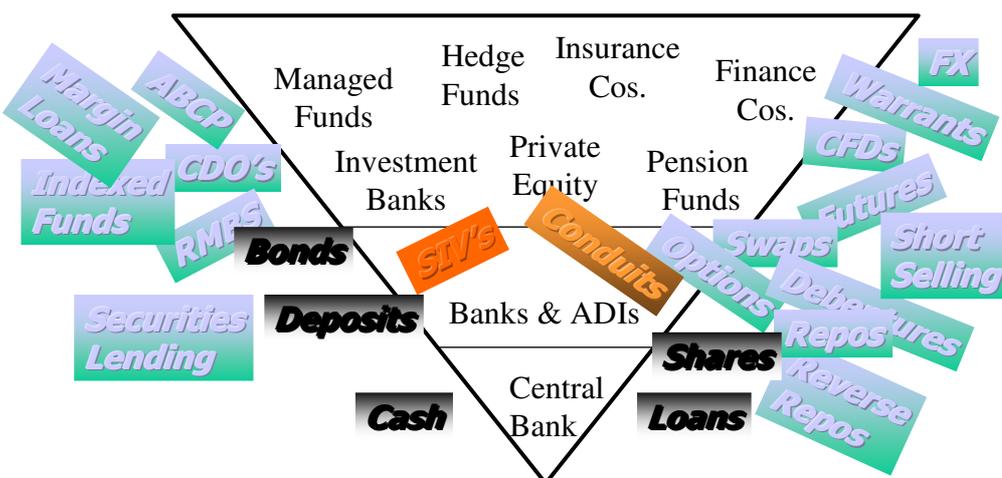
Regulatory Responses

- Protection of national banking systems
- Liquidity Creation/restoration
- Bail Outs
- Temporary regulations

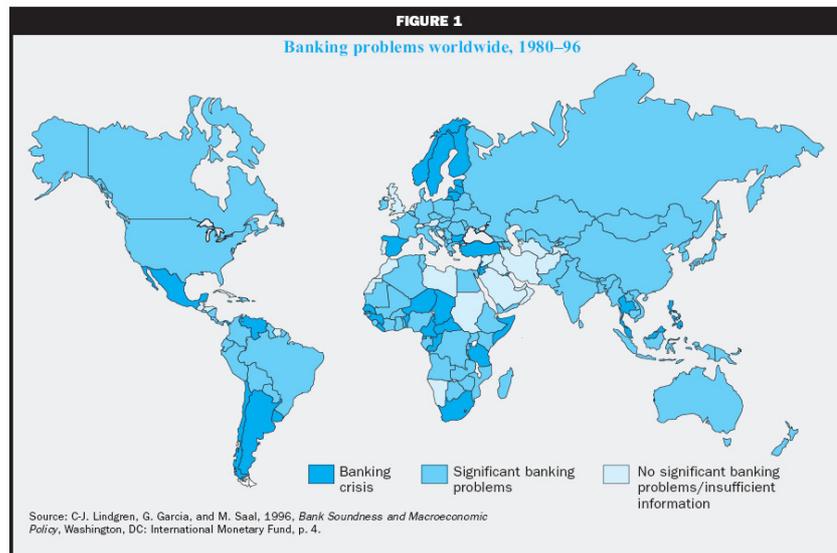




A Fragile Financial System?



Banking Crises: 1980-96



Financial Crises since 1996

- Asian crisis 1997
- Russian crisis 1998 (& Long Term Capital Management)
- Brazil 1999
- DotCom Bubble 2000
- Argentina 2001
- “since the collapse of Argentina in 2001, the international financial system has been an oasis of stability. Some believe this is merely good luck, and that the bad old days will return. They are wrong.” [Andrew K. Rose](#) 31 May 2007 [CEPR Policy Insight No. 1, June 2007](#)
- <http://www.voxeu.org/index.php?q=node/199>
- Subprime Crisis – June 2007 - ??

Future Regulatory Issues

- Central Bank targets
- Macro-prudential policy
- Mark-to-market accounting
- Deposit Insurance
- “Too big/important to fail”
- Automatic recapitalization stabilizers

Future Regulatory Issues

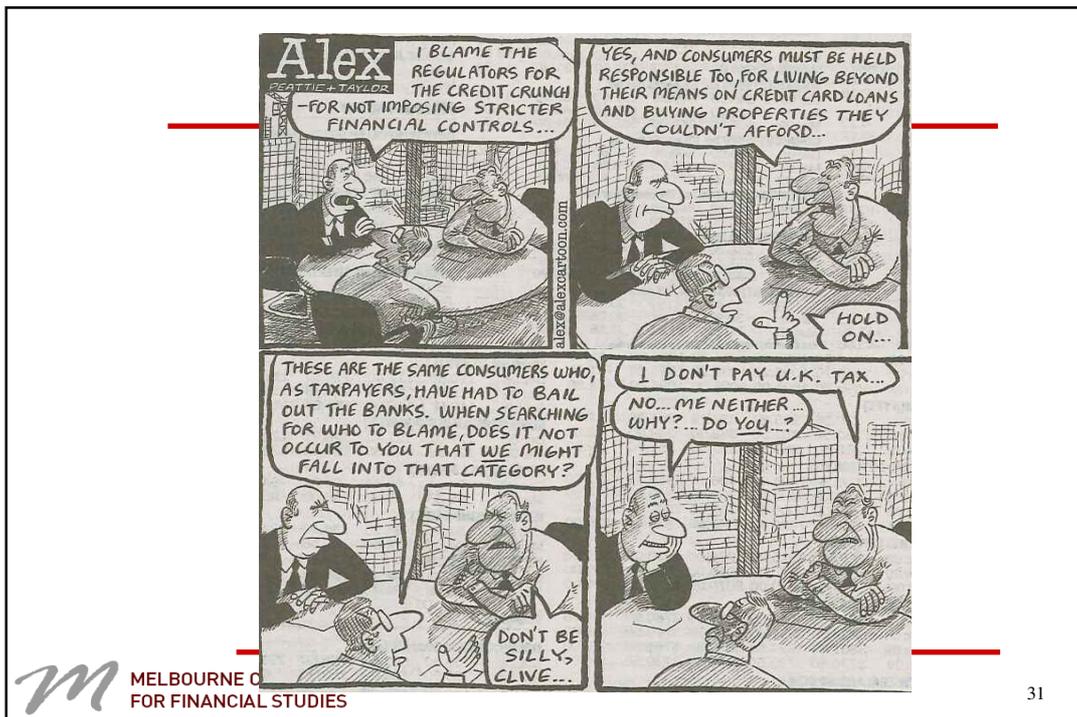
- Basel II
- Domain of Prudential Regulation
- Reporting and Information Requirements
- Promoting organized exchanges
- Transactions taxes and volatility

Future Regulatory Issues

- Governance and agency problems
- Financial consumer protection
- Securitization structures
- Financial sector concentration

Conclusion

- Was it inevitable – probably!
- Who's to blame – enough for all to share!



Conclusion

- Was it inevitable – probably!
- Who's to blame – enough for all to share!
- Will a depression result – probably not!
- Will similar financial crises recur – probably!
- Will the financial system be restructured
 - Needs to be, but vested interests are strong!