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A Conversation with **Harvey Rosenblum**

The Dangers of Complacency About Risk

Dallas Fed Research Director Harvey Rosenblum discusses the stability of the U.S. economy's Great Moderation and how it set the stage for the financial turmoil that has gripped the nation since August 2007.

Q. Would you explain the term *Great Moderation*?

A. Economists use it to describe the marked decline in the frequency of recessions over the past 25 years. A less volatile macroeconomic performance was accompanied by big reductions in inflation and inflation volatility. This environment changed expectations. Inflation and inflation expectations are the keys to economic stability because they're the primary drivers of changes in interest rates over long periods.

One way this relationship affects the average American is through its impact on mortgage rates, which also rise and fall based on inflation and inflation expectations. As interest rate volatility nearly disappeared in recent times, home mortgage rates declined appreciably, making the American Dream of homeownership more affordable.

Q. So far, this sounds positive. How did we get from there to the irrational behavior we've heard about in the housing and mortgage markets?

A. We have to realize that some of the irrationality that characterized the years leading up to the credit crisis was a by-product of the economic tranquility being experienced. The Great Moderation induced a feeling of minimal risk, but the feeling did have an aura of rationality to it.

Indeed, it may have been quite rational to have faith in positive outcomes, to become a bit complacent, given the economy's increased and prolonged stability. The real question is, how do you draw the line between rational complacency and misplaced confidence?

Q. And the answer to that question is…?

A. At a certain point, complacency began to feed on itself; it became a psychological state that fed on laziness and overconfidence. As a result, financial market participants' incentives became perverse, misplaced and misguided. But financial markets and the economy remained calm, so the complacency didn't raise as many red flags as it should have. Regulation and market discipline were always one or two steps behind events.

Q. How did this complacency manifest itself?

A. Through what I call the three corollaries of complacency—complexity, confidence and compensation. The first of these concepts gets at whether managers can figure out what's going on within their own organizations.

Take the obvious example of a bank, which we have to remember is a regulated entity. Can the CEOs describe their organizations' structure and investment risks to their 12-year-old grandchildren? Are objectives other than safety, soundness and shareholder value being pursued? Or is the complexity of the corporate structure a way to hide things from top management and shareholders? If so, there should be a rating penalty; every effort at obfuscation must be "taxed." It's fine to have a far-flung empire. It's not fine for it to be subsidized by shareholders, investors or, perhaps eventually, by taxpayers.

Q. And the second C: confidence?

A. I think of confidence as a component of liquidity, which isn't one of those things you can easily measure. We've quickly learned that it's more like a switch that's either on or off. The crux of liquidity is whether you can sell something quickly for cash at a price close to the last trade. If you can, then an asset is liquid. But when market confidence starts disappearing, it takes liquidity with it, especially during turbulent times, when a flight to quality is almost certain.

I would be remiss if I failed to mention a separate aspect of liquidity that crept back in the recent complacency: a classic mismatch of long-term assets funded by short-term liabilities. In the current crisis, it has shown up in bank off-balance-sheet entities funded with very short-term commercial paper backed by long-term assets of questionable quality.

Commercial paper has traditionally traded at rates very close to similarly short-term Treasury rates. The underlying assumption behind every asset–liability mismatch is that you can indefinitely fund your liabilities at something close to short-term Treasury rates. What banks discovered the hard way is that no market can provide a perfect substitute for the U.S. Treasury market.

Q. Does it bother regulators that they're once again dealing with the repercussions of off-balance-sheet financing?

A. Not necessarily. A little background on the workings of commercial banks helps here. The sustainable competitive advantage commercial banks have over their nonbanking competitors is the safety net that encompasses the Fed's discount window and federal deposit insurance. Commercial banks voluntarily "pay dues" to be among the financial

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institutions that are more closely regulated. The advantage of membership in this club is that it provides a solid means of funding in both good times and bad.

What we're grappling with today is that some banks have effectively bent the rules under which they've agreed to be regulated by creating these off-balance-sheet entities that are very difficult to track. Why they did this leads us to the subject of incentives, or the last of my three *C*'s of complacency—compensation.

Before the current crisis hit, it appeared the incentive systems were operating as they were meant to, as a guide for people to maximize company profit and shareholder value. But in retrospect, these incentives seem perverse. They encouraged increasingly risky lending by compensating people for the number of transactions and not for the long-run return on investment financed by these transactions.

Q. Can you give us an example?

A. The most obvious one comes out of the mortgage banking industry. For starters, the entire industry really changed when savings and loans became less of a factor in mortgage lending. The S&L decline in the 1980s resulted in a critical shift away from a business model that might be deemed quaint these days: A lender specializing in mortgage loans knew it would hold them to maturity. As a result, the incentive was to lend to borrowers who had the means to repay, with the loans collateralized by property that wouldn't decline in value. The risk was that you funded these assets with deposits, liabilities whose maturity was much shorter than the assets'.

The S&Ls' fall opened the door to a cottage industry that made mortgage loans on behalf of a wide range of investors who wanted to hold mortgage debt. In this new business model, you originated loans with the intent of selling them to investors rather than holding them. You got paid for making loans. Looked at differently, every loan denied was time and income forgone. So the incentive was to get investors to be flexible about what long-term assets they were willing to hold.

In a relatively short time, the industry went from a platform of homogenous, plain vanilla mortgages that may not have met all borrowers' needs to an amalgam of customized mortgages with adjustable rates, zero or low down payments, interest-only payments and looser standards for documentation of income.

Q. How does that tie into our recent troubles?

A. The Great Depression taught us mortgages could be risky products. House prices fell when unemployment rose. For many years after the Depression, national banks weren't allowed to hold mortgages because they were viewed as too risky. Fifty years of home mortgages being much less risky changed all that, abetted by the Great Moderation.

Q. I doubt many people today would describe mortgages as "less risky."

A. It doesn't help that the housing industry has been hit by what has been described as the equivalent of a 100-year storm. But unlike an uncontrollable event in nature, I think the storm in the housing market might have been prevented.

Homes have always been depreciable assets. They appreciated only if you kept blowing money into them, kept improving and modernizing them. But at some point, the public began to believe that homeownership was a party you had to attend, that house prices could go in only one direction—up.

Feeding this perception was that cottage industry of mortgage lenders and investors grafted onto the existing mortgage industry structure. We saw a tremendous expansion of lending. Money flowed in from all over the world to support it. The pervasive complacency, however, meant many investors didn't adequately consider the risks involved, particularly when it came to the innovations in the subprime segment of the mortgage market.

Not all of this financial innovation was bad, mind you. The positive spillover is that many Americans have better access to mortgage credit and homeownership rates have risen sharply. And much of that money flowed to responsible borrowers who are fully discharging their repayment obligations. Many of them wouldn't have had access to mortgage credit under the "quaint" business model of the late 20th century. The democratization of the mortgage market—and other segments of the credit markets as well—is something that, on balance, we should celebrate.

Q. So how do we navigate, and presumably escape, this perfect storm's path?

A. Until we have a sense that house prices have stopped falling, it's hard to say how long the current turmoil will last. But let's not lose sight of the fact that there will be a bottom to this market. And it's probably not all that far away. The Fed is using every tool at its disposal and creating new ones to mitigate the damage this storm is inflicting on the economy. The Fed has been rewriting the textbook on economics and finance. The Fed is clear about its mission, and I believe we're succeeding.

Editor's note: Two Dallas Fed Economic Letter *articles offer background on the issues discussed here. See "The 'Great Moderation' in Output and Employment Volatility: An Update," by Evan F. Koenig and Nicole Ball, September 2007, and "From Complacency to Crisis: Financial Risk Taking in the Early 21st Century," by Danielle DiMartino, John V. Duca and Harvey Rosenblum, December 2007.*