Ten years later: What did we learn from the subprime storm?

By David Parkinson
August 12, 2017 – *The Globe and Mail*

National Bank of Canada president and CEO Louis Vachon remembers the moment, 10 years ago this week, when it became clear to him that the problems facing his bank went an awful lot further than his bank. A simmering crisis in the financial sector was coming to a boil, and it was going global.

National Bank was one of the biggest players in Canada's market for asset-backed commercial paper (ABCP) – a relatively new concoction made up of bundles of various kinds of debt, including risky U.S. subprime mortgages. It was designed a short-term investment, a place to park cash for supposedly safe return.

But by August, 2007, concern about the severely-stressed U.S. subprime market was fuelling a liquidity crunch. On Aug. 9, a major European bank, BNP Paribas, suspended three of its investment funds with holdings tied to U.S. subprime-backed securities, taking the situation from bad to worse. As investors everywhere scrambled for the exits, National Bank had ABCP notes coming due, but no one was willing to buy new paper to fund the repayment of the expiring notes.

National Bank called its foreign bankers who had helped fund its ABCP program, and who had pledged to extend emergency lines of liquidity in the event of a "market disruption." Mr. Vachon and his colleagues at National Bank believed this certainly fit the bill.

The bankers refused.

"It was a signal that the problem was so global and so large that they were probably not even in a position to respect these [liquidity] lines," Mr. Vachon said in an interview this week. "That was the moment when we felt we had a serious problem."

The global financial crisis wasn't one of those, "Where were you when the planes hit the Twin Towers?" events, a single dramatic day that instantly changed the world.

Most observers, including Mr. Vachon, didn't see August, 2007, as a critical turning point in a full-blown crisis until more than a year later, when U.S. investment bank Lehman Brothers famously collapsed. Others would point to the bursting of the U.S. housing bubble in the fall of 2006 as the true start of the crisis, the snowball that turned into an avalanche: Slumping home prices, a failing U.S. subprime market, flight from derivative products built on mortgage assets, tightening credit, bankrupt hedge funds, the collapse of U.S. investment bank Bear Stearns, a stock market crash and a deep recession.

But in retrospect, we can see August, 2007, as the moment when it all began to tumble down. Economists have a name for such a tipping point: The "Minksy Moment," named for the late American economist Hyman Minsky, who spent a career studying financial crises and was convinced that financial markets were prone to speculative excesses that inevitably collapsed in crisis – and the more extreme and longer a period of excess, the harder the markets would fall. Mr. Minsky passed away in 1996, but boy, did the crisis of 2007-08 make him look smart.

The BNP Paribas decision was followed quickly by the freezing of Canada's $32-billion market for third-party ABCP a few days later. Central banks, including the Bank of Canada, quickly stepped in emergency liquidity into the financial system to keep the markets moving; but the mere fact that they had to do so underlines the significance of the events of those dog days of summer a decade ago. Whether we knew it or not, we were in the worst financial crisis since the Great Depression.

Over the course of the next two years, the crisis would fuel the deepest global recession in 70 years; only drastic intervention by central banks, and an injection of massive deficit spending by governments, staved off a second Great Depression.

While estimates vary wildly on the global cost of the crisis, it's safe to say it was in the tens of trillions of dollars in lost GDP, asset values, savings and income. It took the stock market more than five years to recover from its losses. (The Canadian equity market is still a little bit below it 2008 high.) Even a decade later, the global economy continues to labour under the weight of the crisis's lingering effects.

And while Canada was often held up as a bastion of financial stability and sound governance during the depths of the crisis, the seize-up of its ABCP market was among the earliest signs that the problems that began in the U.S. housing and mortgage industries had infected too much of the global financial market to be contained.

"The Canadian ABCP crisis was really the first major liquidity halt of the financial crisis," said Caroline Cakebread, co-author of the 2016 book *Back from the Brink: Lessons from the Canadian Asset-Backed Commercial Paper Crisis.* "It was really the first big one."

The first of a long string of calamities for the global economy, from which we may only now be emerging. Central banks have spent the past decade backstopping the marketplace with ultra-low interest rates and bond purchases to keep the financial system well-primed and stimulate growth. We have whole new layers of financial oversight in place that didn't exist before the crisis – things like Basel III on the global level, Dodd-Frank in the United States, and stronger rules and oversight for ABCP here in Canada – designed to better insulate the system from a repeat of the crisis. In particular, banks have been required to greatly increase the capital on their balance sheets and the liquidity of their assets, and are subjected to regular stress tests to assess their capacity to weather financial-market shocks.

Canada's big banks acted quickly to freeze the at-risk ABCP market and protect it from the threat of defaults while they worked out restructuring plan, but that meant investors were blocked from accessing their money for many months – including thousands of retail investors, who in many cases had parked substantial portions of their savings in ABCP for temporary safe keeping. (Eventually, retail investors got their money back. Institutional investors had their short-term paper exchanged for new long-term notes which only expired earlier this year – nearly a decade after the funds were frozen.

After a decade of finding our way through the post-crisis wilderness, what have we learned?

We've learned that too-clever-by-half financial product creations can't make risk magically disappear. Until the crisis hit, the people who had devised mortgage-backed derivative products such as ABCPs firmly believed that by bundling up pieces of risky mortgages and reselling them, they were spreading the risk of mortgage defaults so thin that they were all but eliminating the danger.

But the reality was that slicing risk up and spreading it around only leaves more investors exposed – especially when that risk becomes largely invisible to the people holding it, as it was in these remarkably opaque products.

"I think the biggest thing that people underestimated was the quality, or lack thereof, of the paper that was at the foundation of this mountain," said Jim Leech, the former CEO of the Ontario Teachers' Pension Plan, who had just been named to the position when the events of a decade ago took place. "You had this whole leveraged system built upon something that wasn't very stable to begin with."

"The credit debacle exposed in 2007 that slicing and dicing securities does not erase the risk of unforeseen illiquidity in dark corners. The relevance today is not in the now hackneyed suggestion that bank capital is stronger and regulators more aware," said veteran independent market strategist Subodh Kumar in a note this week to clients. "Frictionless continuity should not be assumed."

We've learned that rising interest rates can have unanticipated consequences in unstable asset markets. Many observers trade the trigger for the crisis – the collapse of the U.S. housing market – to the U.S. Federal Reserve's steady ramping up of interest rates in the two years prior to the housing downturn. That forced the issue in a housing market greatly over-extended and heavily financed by debt, both at the consumer level and the bank level. It's something central banks around the world must be conscious of as they move to normalize interest rates from their extreme lows over the next few years – not least in Canada, with its own housing-market concerns.

We've learned that an economic recovery from a financial crisis is much harder, and takes much longer, than a recovery from a garden-variety recession. The financial crisis and Great Recession had at their root a complicating factor: Extreme excesses in debt, on all levels. We've seen that this sort of "balance sheet recession," as economists call it, require a slow and painful process of debt reduction by households, businesses, financial entities and even governments before the underlying cause is resolved – and this process itself restrains demand and impedes recovery.

And we've learned that that market participants have a long memory when they've been burned as badly as they were in the financial crisis. A decade removed from the beginning of the financial crisis, eight years since the recovery from the Great Recession began, confidence remains a fickle commodity. Barely a week goes by without something landing business reporters' in-boxes musing about the "next financial crisis" – when it might happen, what it might look like, what will bring the markets to their knees next time. Prior to the 2007-08 meltdown, talk of crises were largely lessons of long-ago history; today, they are a regular part of the discussion.

And while asset prices suggest that investors have been more than happy to pile on the risk again as the crisis has moved further into the rear-view mirror, there is still lingering evidence of a more risk-averse approach to navigating finances in the post-crisis business world. Global business capital investment has barely recovered to its precrisis levels, and it's not because businesses don't have the money to invest: Moody's Investors Service this week published a report showing that U.S. corporate cash holdings topped $1.8-trillion at the end of 2016, about two and a half times their 2007 levels.

Despite growing economies and years of under-investment by the corporate sector, businesses have shown a propensity to horde cash for another financial rainy day – the lesson seared in from the financial-crisis carnage.

But perhaps the biggest lesson we have learned from the financial crisis that began a decade ago is how little we really understood about the inner machinations and complex interactions of our financial system – and, frankly, how little we still understand. Many key market participants knew shockingly little about the true nature of the creations introduced to the financial system in the years preceding the financial crisis, and completely misread how they would unravel under pressure.

By that same token, the financial system 10 years on has its own unknowns – from investors' elevated exposure to risk assets, to Canadians' record household debts, to the massive crisis-era expansion of central bank balance sheets in the United States, Europe, Japan and China. And the regulatory safeguards put in place after the financial crisis to deliver stability to the financial system in times of shock have yet to face a true test.

"Will there be another crisis? The answer is yes. The basis of the economy, the basis of financial markets, is human nature, and we're far from perfection," said Mr. Vachon.

"More fundamentally, the real issue – and I think the work that has been put in place by regulators and the banking industry – is not so much to avoid another crisis but to make sure it doesn't have the same macro-economic, social and political impact."