The subprime solution: how today's global financial crisis happened, and what to do about it?

by Robert J. Shiller

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Reviewed by Russell Thomas SA Fin,
Director of Policy and Regulatory Affairs, Finsia.

With his trademark polish and accessibility, Shiller dissects the collapse of the US mortgage and housing markets, explains the impact on the wider credit markets and proposes a series of bold solutions for policy makers. Departing markedly from orthodox thinking on regulatory reform, he calls for market-based solutions to minimise the impact of housing bubbles, and for industry leaders and policy makers to promote the conditions for a more vigorous real estate and financial environment in the future.

The subprime solution is to the housing bubble what his earlier and popular work, *Irrational exuberance (2000)*, was to the 1990s equity markets: an astute interpretation of economic history and a controversial primer on how financial markets will benefit more from 'democratization' than from tighter regulation.

Readers who have grown weary of the emphasis by policy makers on 'bailouts, regulations, rules, penalties and prison sentences' will be buoyed by Shiller's prognosis. The different approaches of the United States and European countries to the Great Depression have implications for governments today. In Shiller's view, the US response in the 1930s was to strengthen the financial sector: 'The mistaken venting of European hostility on smoothly functioning financial markets was fully appreciated only half a century later. We need to maintain this financial enlightenment'.

Shiller explains that a good deal of economic inequality in the modern world is due to the persistence of unmanaged risks and that the *technology* of finance is ideally suited to dealing with these risks. His thesis is elegantly structured. Chapters 2 and 3 provide a historical review of the last major housing crisis in the United States (1925–33). Shiller clearly articulates the causes and immediate consequences, but focuses firmly on the institutional innovations that, in his view, have proved to be resilient. For example, he details the establishment of a Federal Home Loan Bank System and, in the private sphere, the professionalisation of real estate appraisers, among others.

Of course, these innovations did not safeguard us against the current crisis. Shiller's argument is clear and subtle – financial bubbles are as unavoidable as the measures taken to minimise their impact are necessary. He argues that the response of government today has been 'disappointingly limited relative to that in the 1930s'. Chapter 4 addresses the immediate short-run responses by government and business leaders to the bubble and its aftermath: 'Bailouts must be done promptly and correctly, so that they do not come across as unjust or unfair'.

In the 'Promise of financial democracy' (Chapter 6), Shiller calls for stronger risk management institutions to inhibit the growth of bubbles 'and to better enable the members of our society to insulate themselves against them when they do develop'. Eschewing the many calls for greater regulation of mortgage origination and property-related investment, Schiller argues for improvements in financial information structure. Most readers will be familiar with his proposals, such as: tax subsidies for financial advice; disclosure of adviser remuneration streams; and the establishment of a consumer 'watchdog'. More interesting are his recommendations regarding default-option financial planning, which involve the extension of workplace pension schemes to general savings accounts and the introduction of more prudent standard terms in mortgage contracts. The requirement for every mortgage borrower to have the assistance of a professional akin to a civil law notary is also mooted (in Germany, Shiller explains, notaries assist in the understanding of contractual terms).

Where Shiller departs markedly from orthodox thinking on regulatory reform is in calling for market-based solutions to minimise the impact of housing bubbles. His is a brave stance. For over 20 years, Shiller and his team have been building indices calculated from data on repeat sales of single family homes. He believes that a liquid market in real estate futures would present profit opportunities for short sellers and that they, by their actions, reduce the potential for a speculative bubble. According to Schiller's thesis, the existence of these markets would allow institutions to 'launch retail risk management products, and then hedge the risks they acquire in doing so'.

The causes of the subprime crisis are now well documented. In a sympathetic note, Shiller reminds his readers that the 'advent of subprime mortgages … reflected a start, albeit primitive, towards … democratizing finance'. He says, however, that for all their lofty social aspirations, these mortgages were 'a disaster in their implementation'. On this score, Shiller has a number of proposals, including a new kind of home mortgage called a *continuous workout mortgage*, which would 'have terms that are adjusted continuously' (in practice monthly), in response to evidence about changing ability to pay and changing conditions in the housing market. In Shiller's view, these would be a form of 'responsible' bailout. Set up in advance, these devices would avoid costly bankruptcy proceedings and adjust the terms of a loan to the borrower's ability to pay. To minimise the potential for moral hazard, Shiller argues that *occupational income indices* could be incorporated into contracts. These are indicators of the earning ability of others in the same geographic area and occupational category. While these mortgages would be privately offered, Shiller's proposals require greater involvement on the part of government and regulators in improving standard contractual terms.

In a recent interview, Shiller admitted that he found inspiration for this recent book in John Maynard Keynes' *Economic Consequences of the Peace*. The Allied Powers, we know now, were making a colossal mistake in demanding the kind of crippling war reparations that led only to resentment and default of the worst kind. In the *Subprime Solution*, Shiller is evoking the same Keynesian spirit for integrated and expansive thinking. He certainly wants policy makers and industry leaders to correct the current crisis, but he also wants them to promote the conditions for a more vigorous real estate and financial environment in the future. Readers might not be persuaded by all of Shiller's proposals, but they will benefit from his extensive insight into previous housing bubbles and the institutional responses by both government and industry. Although many of his solutions would require some level of regulatory oversight, Shiller refreshingly avoids any detailed discussion of regulation. Above all, his belief in the better angels of financial innovation will sustain the morale of his enthusiastic supporters.