Discussion of

Who Neglects Risk? Investor Experience and the Credit Boom

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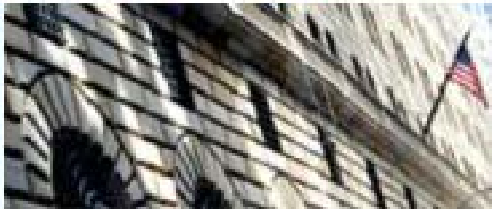

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- The views in this presentation are my own, and do not represent the opinions of the Federal Reserve Bank of New York or the Federal Reserve System.

Summary: Once Bitten, Twice Shy

- Key result: decision by fund managers to invest in nontraditional securitizations (NTS) during boom was shaped by personal experience and beliefs.

- Specifically, more NTS investment by managers who were …
  - less experienced,
  - living in areas where home prices grew quickly,
  - not managing in 1998 when LTCM collapsed (or did well in 1998),
  - top performers or far removed from personal poor performance,
  - working in a *fund family* that avoided losses in 1998,
  - less formally qualified (not CFA holders).

- Past losses, or CFA qualification, mitigates effects of inexperience (interaction effects).

Big picture: beliefs and booms

- Growing evidence many “insiders” did not expect housing crash; had optimistic beliefs about home prices & mortgages:
  - Gerardi et al. (BPEA 2008): Wall Street analysts put very low weight on possibility of significant home price decline.
  - Cheng et al. (AER 2014): Mortgage brokers etc. very long housing.
  - Bank CEOs didn’t divest ahead of crisis (Fahlenbrech and Stulz JFE 2011). Bear Stearns 1/3 employee owned when it failed etc.

- Where this paper fits in:
  - Cross-sectional evidence on who had optimistic beliefs.
  - Finds that optimism is related to lack of experience with “bad times”.
  - Suggests that long quiet periods can lead to optimism and bubbles.

Reactions

- Very clean, easy-to-follow, well written paper.
- Clear question and takeaway point. Complements prior work studying equities investors during internet bubble.
- Overall – found results to be both interesting and convincing.

Two main comments:

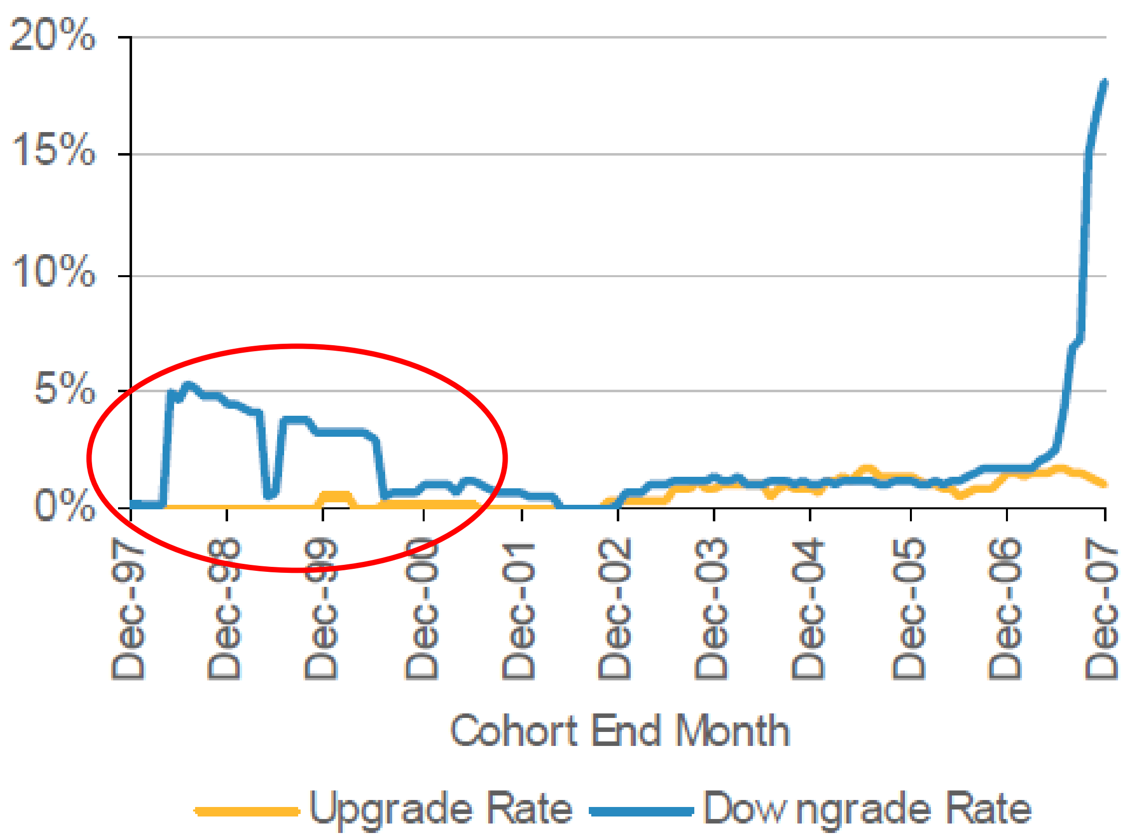
- How “nontraditional” was subprime? Role of past experience with this market?
- Do more on role of home prices in shaping beliefs.

How nontraditional was subprime?

year	subprime originations $bn	subprime originations % of all mtg	subprime securitization rate (% of originations)
1995	$65	10%	28%
1996	$97	12%	40%
1997	$125	15%	53%
1998	$150	10%	55%
1999	$160	12%	37%
2000	$138	13%	41%
2001	$173	8%	55%
2002	$213	8%	58%
2003	$332	9%	59%

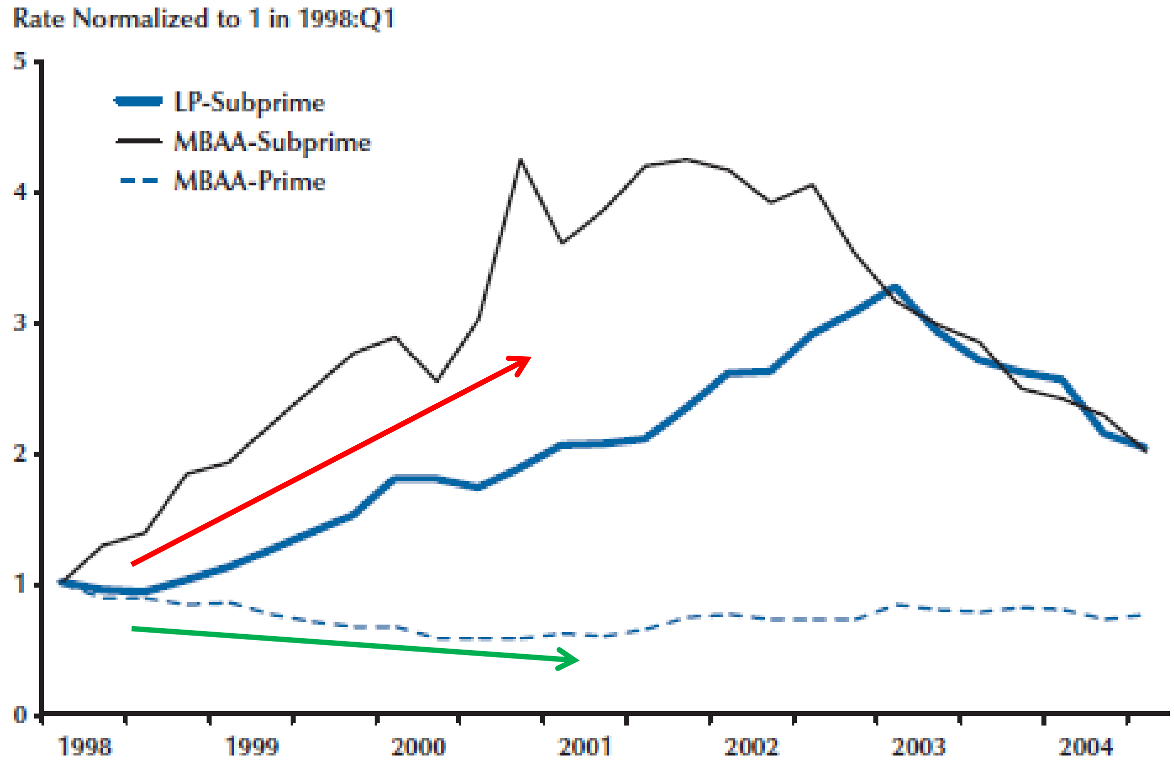
Source: Chomsisengphet and Pennington-Cross (2006), derived from Inside Mortgage Finance.

Rating upgrade/downgrade rates, home equity



Source: Moody's (2008)

Foreclosures in progress: subprime and prime



NOTE: The rate of foreclosure in progress is normalized to 1 in the first quarter of 1998. MBAA indicates the source is the Mortgage Bankers Association of America and LP indicates that the rate is calculated from the LoanPerformance ABS data set.

Source: Chomsisengphet and Pennington-Cross (2006)

Did personal experience *with subprime MBS* matter?

- End of 1990s: spike in defaults & rating downgrades. String of failures among subprime lenders and investors (e.g., Aames Capital, United Companies).
  - Foreshadowing of the 2007-08 subprime crisis?

- Questions for authors:

1. To what extent is “1998” dummy picking up subprime issues, rather than general turmoil associated with LTCM & Russia?
   - Matters for interpretation. Are beliefs general or asset-class specific?
2. Exploit earlier episode? Test: Did managers & funds holding subprime ABS in 1998-99 invest less in 2004-07?
   - Alternative hypothesis: “This Time It’s the Same” (Fahlenbrech et al., 2012, JF)

Home prices and beliefs about NTS

- Inexperience result concentrated in regions with high HPA.

	(1)	(2)	(3)	(4)
Inexperienced	3.421	1.896	3.226	1.760
	[3.75]	[1.48]	[3.54]	[1.39]
High local HPA	1.969	0.316	2.312	0.715
	[2.16]	[0.40]	[2.13]	[0.84]
High local HPA		3.259		3.175
× *Inexperienced*		[2.05]		[1.94]

- Cool result! Speaks directly to home price experiences. Link to work on extrapolative expectations (Glaeser-Nathanson, 2015).
- Only marginally significant though. How robust? Kick tyres:
  - Add other MSA controls (e.g., income per capita) and interactions
  - Use nonhousing ABS as a control group
  - Different specifications for HPA (why top tercile?)
  - Any chance this is picking up regional home bias effects?

Other comments

- Why is timing of becoming a fund manager the key date for belief formation / experience? These people were presumably working in asset management / Wall Street beforehand…
- Seems like many of the lessons & findings of the paper are much more general than just NTS.
  - More general test: greater risk-taking by mutual fund managers who haven't experienced "bad times"?
  - Already been done? (aside from Greenwood-Nagel 2009 JFE)
- In table 9, authors interpret decline in par value as a measure of credit losses / writedowns. But what about prepayments?
  - Not clear to me that this interpretation is right.

Final comments

- Takeaway for future of nonagency MBS securitization?
  - In the short run, everyone recalls the wave of subprime defaults.
  - But eventually the "veterans" are replaced by new investors who didn't live through the subprime crisis.
  - Suggests slow recovery as beliefs mean-revert.

- E.g.: rating of US CMBS by rating agencies after CRE crisis:
  - AAA subordination = 30% in 1996 (Stanton-Wallace, 2010).
  - Fell steadily to 12-15% by 2007.

- Thinking about today -- many people on Wall Street have never experienced monetary tightening or inflation > 2%!