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The Global Financial Tsunami - 2008

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Abstract
In 2008 a series of bankruptcies of financial institutions led the United States and the principal economies of the world into a recession of great magnitude that required exceptional government intervention.

It started on September 14\textsuperscript{th} when Lehman Brothers announced that it was entering into chapter 11 bankruptcy. After this, there was intervention in recognized multinational corporations like Fannie Mae, Freddie Mac, and American International Group. There were also the bank failures of Washington Mutual and Citigroup.

The main cause of this crisis was the excessive level of leverage of the financial industry, which had its roots in the real estate boom and subprime mortgages. This paper explains the outbreak of the Global Financial Tsunami and the fallout of the financial industry in 2008. The document is organized in the following order: the first part is an introduction, second gives a background of the crisis, third is an explanation of the "Emergency Economic Stabilization Act", fourth explains the concept of market psychology, and finally conclusions and recommendations.
1. Leading factors to the crisis
The decade of the 1990s is considered as a period of a real estate boom in the United States, in which property prices increased out of control. Graphic 1 shows the housing prices (inflation adjusted) in the United States and also the pattern that it followed before the crises started. For more than a decade the prices of real estate were growing too rapidly. This growth coincided with the merging of two financial industries that due to regulation never before were together: investment banking and commercial banking.

Graphic 1 - Inflation adjusted U.S. house prices

Source: S&P and own calculations [9]

The principal businesses of investment banks are underwriting new stock and bond issues, selling new securities in the primary market, and helping investors trade securities in the secondary market. On the other hand, commercial banks business is to take deposits and make loans.

The Glass-Steagall Banking Act of 1933 was established in the United States to control speculation. The act prohibited banks with deposit-taking business to operate investment-banking businesses. As investment businesses have more risk involved, the act tried to protect depositors. This requirement was abolished when the Gramm-Leach-Bliley Act was approved in 1999 allowing the formation of universal banking, that is, banks that can perform both activities.

After the merge, the universal banking industry started to create new products that allowed them to give a new configuration to the lending business. In a traditional loan, borrowers initially received an amount of money from the lender (the commercial bank) and they were obligated to pay back by equal amounts of money (principal and interest) to the lender at a later time. Under this approach, the lender held the risk that the borrowers did not pay until the last payment is completed. The advent of the mortgage-backed security (MBS) changed completely the way industry made loans and also lowered the lending standards. This instrument represents a claim on the cash flows from mortgage loans through a process known
as securitization. The securities must be accredited by a rating agency; and loans should come from the top two ratings \(^1\).

Even though this new method gives more liquidity to the industry, and helped to spread the risk among the market participants who buy the instrument, this simultaneously creates a moral hazard. Banks selling the securities in the market paid credit rating agencies to accredit their securities, both parties had an opportunity to gain from acting against the principles laid out by the agreement \(^2\). From one side, banks were lowering the standards of subprime\(^1\) lending because with MBS banks do not hold the mortgages until the end. Once they package enough mortgages and put them in the market, the default risk belongs to the investors of the securities. From the other side, credit agencies had an opportunity to gain from performing poorly in assessing the risk of securities as they earn revenues for the quantity of ratings they made and not from the quality of them. As an example, forty percent of Moody’s revenues in 2005 came from rating securitized debt.

During the decade before the financial tsunami, banks were also making money through credit default swaps (CDS). This is a form of insurance on a bond or a security like an asset backed security, where the insurance company promises to pay off the security if the issuer goes bankrupt or fails to make the repayment in return for an insurance premium.

As CDSs are over-the-counter (OTC) agreements, people or institutions do not necessarily have to own the bond to be insured (naked CDS) and as they are sold in an unregulated market, insurance companies do not always have the capital required that would enable them to fulfill their commitment to the insured counterparty. This could happen when there is too much pressure on the market about the default of a company or security; eventually this could make the insurance company sell undercapitalized CDS. Institutions like banks started using CDSs as a bet on the likelihood of mortgage backed securities to default. It looked like a good business for banks, as they thought they knew the quality of the loans from the MBS. Once the MBS was in trouble, credit agencies gave the security a lower rating and the price of the CDS would have gone up, the banks sold the CDS at a better price and made their profit \(^3\). Companies like AIG sold insurance contracts to the banking sector in the United States but AIG did not have the proper level of reserve capital to respond to its contingent obligations. When AIG did not pay all the swap contracts they insured, banks had to face big losses on their income statements.

In summary, the real estate bubble was produced due to the liquidity that the new banking sector introduced to the market through MBS. The banking sector thought they were making a safe bet by investing in naked CDS without thinking in the risk of default of insurance companies in the OTC market. Once home prices peaked, creditors started to fail on the repayment of the debt as most of them did not have the capacity to repay the loan, home prices started going down and banks started to go bankrupt when they were forced to acknowledge huge write downs and write offs on these products. \(^4\)

\(^1\) Borrowers with a limited credit history or that could have difficulties to make repayments of the debt.
2. Responses to the crisis
During October of 2008 the House of Representatives in United States passed the amended version of the "Emergency Economic Stabilization Act" that sought to rescue the economy from collapse. The "Bailout bill", as it was also known, had many supporters and opponents. Those in favor argued that the plan was vital to prevent further erosion and a complete collapse. Henry Paulson summarized the plan’s intent: stabilize the economy, improve liquidity and improve investor confidence. Opponents believed that taxpayers should not pay for the irresponsibility of Wall Street.

The principal proposals of the plan were:
1. Troubled Assets Relief Program (TARP): Under this program the U.S. government bought up to 700 billion dollars of troubled assets and equity that were illiquid and difficult to value, from banks and financial institutions [5].
2. Executive compensation: This part of the act was made to restrict executive compensation of companies that were selling assets to the U.S. treasury.
3. Help for homeowners: Treasury bought trouble MBSs, mortgages and residential assets to reduce the foreclosure and inject liquidity to the market.
4. Taxpayers protection: In case that government has losses after 5 years, the financial institutions that participated must reimburse the taxpayers.

3. Market Psychology
It is very important to understand two concepts that were present during the crisis and that are now relevant to know how the crisis should be faced: “market psychology” and “human nature”. Keynes described the human behavior as instinctive rather than rational or calculated. In other words, when we make decisions we do not rely on complicated equations that we formulate in our minds; it is the result of an “animal spirit” that reacts spontaneously to an action that makes us choose among alternatives. As markets are sums of people, the psychology behind them is also not rational and regulators should be aware of this as they design the legal framework of a country.

In the case of the U.S., it appears that the government did not take into account this perspective before and after the crisis. During the decade before the housing market drop of 2008, the regulation framework was too flexible. It allowed people and institutions to take on a lot of risks in unregulated sectors, or where the regulation was not clear or specific. People and institutions thought that they could take advantage of an unregulated market, but unfortunately they were carrying it to edge. After the program of stabilization started in 2008, it spent more than $700 billion buying troubled assets and equity. The U.S. government decided to start a program of fiscal austerity to reduce spending, they cut a large number of jobs. People’s reaction to this new policy was unexpectedly negative, instead of feeling confident about austerity, individuals and companies felt more fear than before and reacted by stopping investment.

Even though the debt problem is still high, the U.S. government should follow the Keynesian vision about human nature and focus on recovering consumer confidence.
4. Conclusion and Recommendations

As was highlighted above, one of the main reasons of this crisis was the excessive leverage of the financial industry and homeowners. During the years before the real estate bubble burst, the lending standards were declining and this increased the average leverage in the economy. The median down payment went down to 2% in United States during 2005 and in countries like England people could borrow as much as 125% of the house value. In other words, there was no collateral to secure the repayment of the loan. In the case that the borrower defaults, the borrower does not have the motivation to repay the loan as there was not much equity involved [6]. The banking sector was growing at a high speed during the decade prior to the crisis but they were also carrying a lot of risk that was transmitted to their clients. Deregulation and creation of universal banking system was the cause of this problem. Commercial and investment banks should remain separate to avoid the risks of one subsector infiltrating another subsector. Also, the government should define clear rules to control leverage in the economy.

A second reason for this crisis is the moral hazard faced by banks and insurance companies and the lack of transparency in the financial industry. There are many instances of lack of transparency involved in this crisis: companies and countries used financial innovation to hide the degree of leverage, banks were making profits when they packaged MBS defaulted in the market, rating agencies were performing poorly in assessing the risk of securities as their profit came from the quantity of ratings they made and not from the quality of them. Regulations should reduce the conflicts of interest that the financial industry faces to ensure professionalism in the operations.

Finally, it is important to see the role of the new financial products, as some of them seem to encourage more gambling than a financial purpose. A naked CDS is an example of these products. People in favor argued that these products give more liquidity to the market. People against these products believe that naked CDS could lead to the imbalance of the market when insurance companies are undercapitalized.

References

