



Module 4

The Role of Global Capital Markets

A Global Financial Crisis (Were the markets to blame?)

Presenter: Paul Kofman

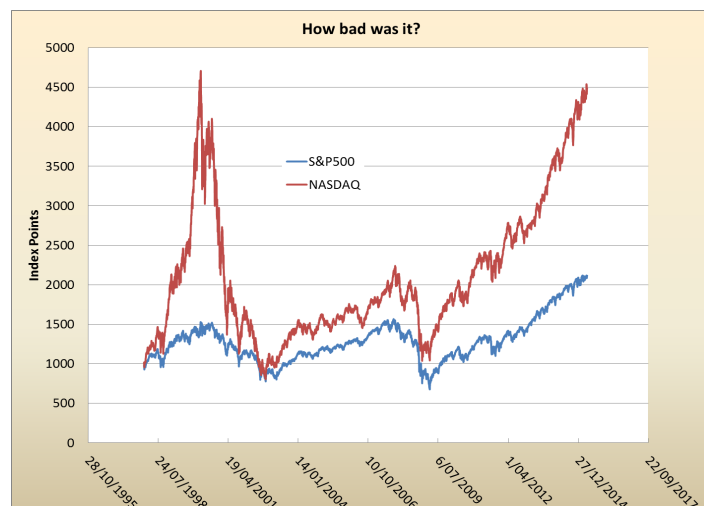


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Drama on Wall Street





Trouble started in residential housing

Mortgage market ballooned in the late 1990s.

- ✓ Cheap money – low interest rates
- ✓ Volume – aggressive marketing
- ✓ >100% Loan to Value ratios
- ✓ Subprime market contested for market share
- ✓ Mortgages funded/package as Mortgage Backed Securities (MBS)
- ✓ MBS then tranching, rated and sold on
- ✗ ... mis-rated, mispriced, misunderstood.

More or less the same story in SME business loans, packaged as CDOs.



A bank run

Deteriorating balance sheets and “off balance sheet exposures” not fully detected by rating agencies.

- ✗ (8/2007) BNP Paribas admits it no longer knows how to value CDOs accurately
- ✗ (9/2007) Northern Rock Bank runs into liquidity crisis funding mortgages
- ✗ (3/2008) Bear Stearns bought by JP Morgan
- ✗ (9/2008) Lehman Bros defaults, then AIG, Wachovia
- ✗ (10/2008) Iceland's major banks collapse, spilling over into Europe
- ✗ (10/2008) UK bails out HBOS, Lloyds TSB, RBS.

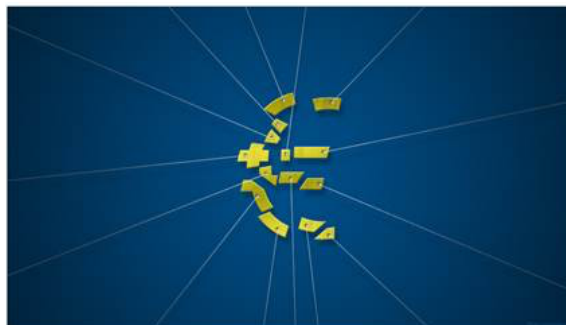




It's a small world...

How a US mortgage crisis bankrupted Iceland and nearly collapsed the EU.

- ✗ Similar economic fundamentals and behaviors affect (groups of) countries
- ✗ (10/2009) Greece in financial trouble – Spain and Portugal follow soon after
- ✗ (4/2010) Greek debt downgraded to speculative grade
- ✗ (5/2010) First bail-out of Greece
- ✗ Recession in most of southern Europe.



What did Europe do to deserve this?

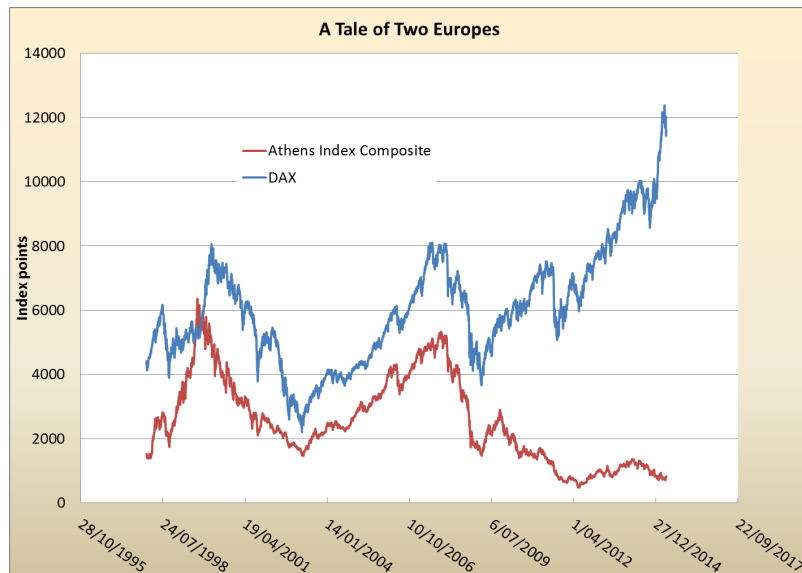
In hindsight the Euro-zone was exposed to global crises.

- A concentrated banking sector, too big to fail, causing significant moral hazard problems
- An integrated monetary regime, ... but segmented fiscal regimes
- A few aggressive growth economies (Ireland, Iceland) borrowing heavily in stable northern European markets.





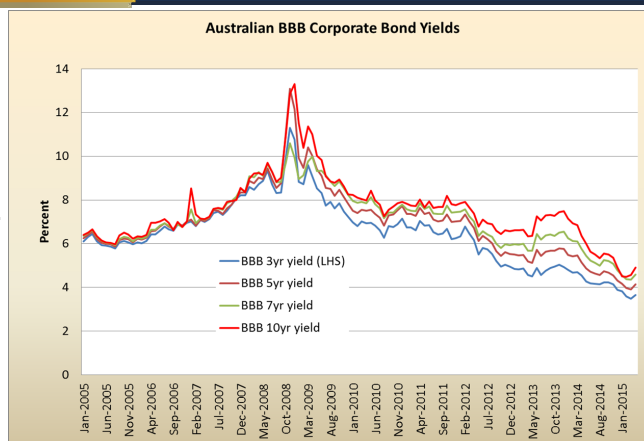
Greek drama



How did it affect corporate financing?

Immediate impact:

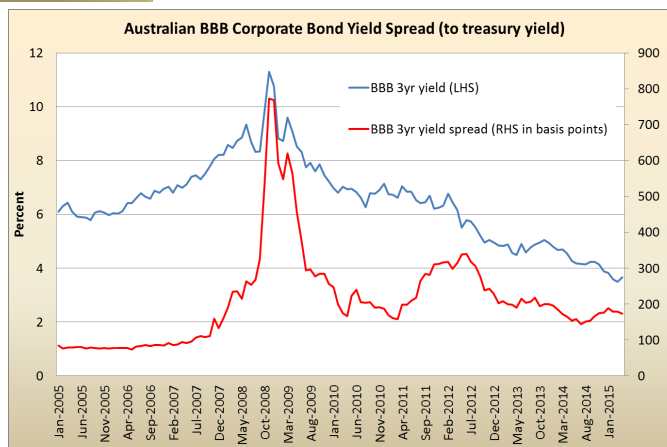
- IPOs disappeared, SEOs became dominant
- Steep increase in the bond yield risk premium
- Diminished financing opportunities.



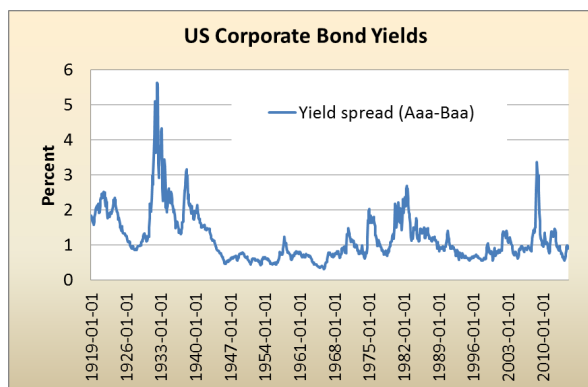
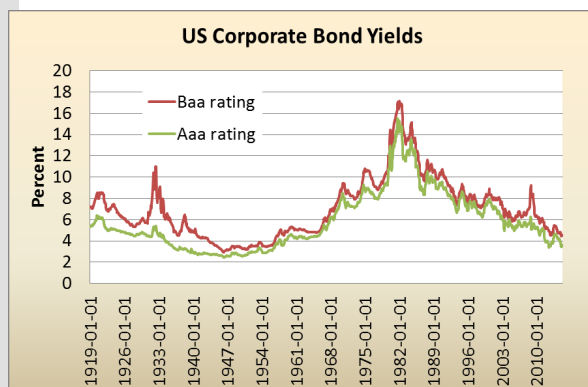


How did it affect corporate financing?

- Investor doubt about “risky” corporations (BBB)
- Drop in demand, Price decrease, Yield increase
- Flight to quality – cash and stable government debt.



Was that so special?





How does it affect corporate financing?

Ongoing impact:

- Continued restructuring of liabilities
- Increased regulatory cost
- Increased liability for directors and officers
- Dilution of share ownership – due to 'emergency' capital raisings
- Diminished funding opportunities for high risk, innovative start-ups
- Changed corporate finances
 - ✓ Less (capital) investment
 - ✓ Cost-cutting, contraction, building up cash positions.

Source list

Slide 2:

Wall Street crisis 2 by Carlos Latuff. (<https://archive.org/details/WallStreetCrisis2>)

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How bad was it? graph: Index Points over time (S&P500 and NASDAQ). Prepared by Paul Kofman from data sourced from Yahoo!7 Finance (<https://au.finance.yahoo.com/>).

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Run on 19th Ward Bank, ca. 1907-1914, Bain Collection (LOC) [Public domain] (<https://flic.kr/p/5poJ3D>)

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Source list

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Euro Debt Crisis - Black and White – Horizontal by EuroCrisisExplained .co.uk [CC BY 2.0 (<https://creativecommons.org/licenses/by/2.0/>)] (<https://flic.kr/p/cUfnLh>).

Slide 7:

A Tale of Two Europes graph: Index points over time (Athens Index Composite and DAX). Prepared by Paul Kofman from data sourced from Yahoo!7 Finance (<https://au.finance.yahoo.com/>). © The University of Melbourne.

Slide 8:

Australian BBB Corporate Bond Yields graph. Prepared by Paul Kofman from data sourced from RBA: Statistical Tables, Reserve Bank of Australia (<http://www.rba.gov.au/statistics/tables/index.html#interest-rates>). © The University of Melbourne.

Slide 9:

Australian BBB Corporate Bond Yield Spread (to treasury yield) graph. Prepared by Paul Kofman from data sourced from RBA: Statistical Tables, Reserve Bank of Australia (<http://www.rba.gov.au/statistics/tables/index.html#interest-rates>). © The University of Melbourne.

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US Corporate Bond Yields graphs. Prepared by Paul Kofman from data sourced from Corporate Bonds, FRED Economic Data, Federal Reserve Bank of St. Louis (<https://research.stlouisfed.org/fred2/categories/32348/downloaddata>). © The University of Melbourne.

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