THE GLOBLE FINANCIAL CRISIS 2007-08

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Course: Financial Markets

Group Assignment Submission 1 - M3

Author's Note

Through this secondary research authors have tried to study the Global Financial Crisis of 2007/8 while emphasising on below points.

i. *The primary causes of the Global Financial Crisis (also known as the financial crisis of 2007/8.*

ii. *The market features and conditions that constitute a financial crisis in general.*

iii. *How the primary causes of the Global Financial Crisis which led to the features of a financial crisis.*

iv. *The response of policymakers and regulators to the global financial crisis.*

v. *The intended effects of policymakers' and regulators' responses.*

vi. *The downsides and unintended consequences that can occur when applying regulation and policy to the financial markets.*

vii. *The features of financial markets which often need regulation.*

Financial Crisis – Characteristics and Cause

Financial Crisis could be loosely defined as a market scenario under which liquidity evaporates because of a significant gap between demand and supply of money. Such a situation often starts with sudden deterioration in the perception of a large group of investors about particular asset class. This change in perception leads to investors rushing to sell underlying without many takers in the market causing a massive decline in financial instruments value. In short duration the financial asset loses a large part of its nominal value, causing significant losses for institutions holding these assets. When banks have substantial exposures to such assets, this situation propagates to the general public. As a result, retail investors and bank depositors worried about losing money by continuing to be a part of these financial institutions, go for mass withdrawals of deposits, causing bank-run. Bank run acts as a vicious cycle, further impacting financial institutions' health and eventually dragging them to a state of insolvency.

Relaxation of financial regulations generally precedes a financial crisis. Institutions incentivised to book short-term gains start circulating assets and work on self-fulfilling prophecies. Driven by the sentiments of the institutions, investors rush to the market without analysing and understanding the uncertainties attached to their investment. They increase their exposure by taking leverage, assuming the up run to continue forever. The situation is extravasated to dangerous levels when reliable information is not available because of opaque or lack of disclosure and absence of restriction on institutions to maintain right asset-liability match.

Common characteristics that could define any financial crisis are:

1. Liquidity Crunch

2. The fragile state of the financial system

3. Loss of trust of the investor in the financial system as a whole

4. Asset boom and burst

5. Regulatory Failure

The Global Financial Crisis of 2007-08

The Global Financial Crisis of 2007/8 is considered by many the worst financial crisis that hit the global market after the Great Depression of 1929. It first surfaced in September 2008 and was marked with the collapse of US investment bank, Lehman Brothers, after which several banks followed suit.

The crisis originated primarily from the US housing market and later engulfed the entire financial sector across the world. Economist around the world attributes financial market liberalization and deregulation as the two prime factors responsible for the crisis.House prices in the US started to increase at a much faster pace from the year 2000 than it had in the previous decade. The US government's keenness to encourage home ownership resulted in the mortgage rates being dropped very low during the period between 2002 and 2005. Additionally, financing institutions in their greed to pocket more commissions on mortgage loans started sanctioning subprime loans under the assumption that house prices will continue to increase forever and with the houses kept as collateral poses virtually no risk. The passing of the "anti-deficiency" law, which protected the public of any personal liability, coupled with the low-interest rate encouraged people to increase mortgage borrowing as a means to make easy money. Consequentially, the period from 2000 to 2006 saw a massive increase in subprime mortgage lending.

Meanwhile, to make the easy profit, investment banks created collateralized debt obligations (CDOs) from the mortgages purchased on the secondary market. The CDOs were perceived to be a promising investment instrument capable of giving high returns in short terms, while the underlying risks associated with them were not properly disclosed. Rating agencies moved from their traditional business of rating bonds, where they had a great deal of experience, to rating CDOs, which were relatively new and had little historical data. In addition to this, there was alway conflict of interest, with financial institutions incentivizing the rating of their CDOs for the rating agencies.

In an attempt to keep making profits by increasing mortgage lending amid rising real estate prices, mortgage lenders and brokers developed Adjustable-Rate Mortgages (ARMs) wherein there was a low "teaser" rate of interest that would last for two or three years and be followed by a price that was much higher. Further, the applicant's income and other information reported on the application form were frequently not checked.

The bubble burst in 2007 when many mortgage holders found that they could no longer afford their mortgages when the teaser rates ended. This led to foreclosures and large numbers of houses coming on the market, resulting in a decline in house prices. As foreclosures increased, the losses on mortgages also increased. Many financial institutions and investors that had taken significant positions in some of the CDO tranches with high leverages, incurred huge losses and had to be bailed out with government funds. Massive losses were also suffered by insurance giants that were protecting these CDO tranches, many of which had been originally given AAA rating.

The financial crisis of 2007/8 had all the recipes required for financial turmoil from the liquidity crunch, fall of the financial system, failed regulations, asset boom and burst to loss of trust of public on the financial system as a whole. The globalization further worsened the situation as the entire global market is interlinked and fall of financial system in the US had the rippling effect on global markets.

Regulations and its Impact

The Global Financial Crisis brought to the forefront the cracks in the regulatory and supervisory system in the financial market. There was an immediate requirement to prevent and reduce the cost associated with the crisis of such a scale which costed US economy alone close to $2 trillion.

Policymakers brought many acts and laws as the reaction to the Global Financial Crisis to answer issues of small capital holdings and management of liquidity by financial institutions; lack of corporate governance and risk management practices; complexity and lack of transparency in banks trading books; insufficient oversight of OTC derivative markets; and most importantly the problem of 'too big to fall' institutions.

The initial response of regulators and policymakers was to infuse capital into the market to bring the market out of the state of crisis. The money was introduced using two principal methods: Interest was reduce making capital available in the market virtually at zero cost and a large number of assets and distresses securities were bought by fed from troubled financial institutions to improve their health. Freely available cash helped to reduce liquidity crunch, and backing of the Fed to financial institution brought back investors' trust on financial institutions.

Consequently, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed in July 2010. The act is the most comprehensive reform after the Glass-Steagall Act of 1929. European regulatory body BIS also came up with advanced framework Basel III as an answer to the crisis.

Dodd-Frank Act established Financial Stability Oversight Council (FSOC). FSOC was authorized to bring under prudential regulations any non-banking institution it found to be of systematic importance. This act made in many formerly free-standing institutions to either converted to absorbed into bank holding companies. Above increased the effectiveness and coverage of regulatory bodies.

Dodd-Frank Act and Basel III also brought in stringent regulations on the capital requirement and its quality to increase the resilience of financial institutions. While Basel laid down the condition for Tier I and Tier II capital, Dodd-Frank Act codified stress testing laws. The attempt is made to make the capital requirement more forward-looking hence more effective. While the Basel committee released a framework to add the capital surcharge on banks of systematic global importance, Dodd-Frank initiated Federal Reserves obligation under section 165 consistent with Basel to further strengthen the big institutions fall of which leads to contagion effect in the market. To also answer the issue of 'too big to fall' Dodd-Frank created orderly liquidation authority. Under this authority, FDIC can impose losses on failed institutions shareholders and creditors, replace institutions management. The likely possibility of losses enhance discipline in the market in participants who earlier assumed exposure to such institutions as a put option and that the government will always bail-out such firms to preclude contagion effect by disorderly failure.

In the period of the financial crisis, for most of the institution crisis started with the evaporation of liquidity which later lead to insolvency. Basel also tried to answer this by bringing in very-short-term and short-term liquidity requirement in the form of Liquidity Coverage Ratio (LCR) with 30 days framework and Net Stability Funding Ratio (NSFR) with the one-year framework. Apart from this many efforts are being made to increase transparency into OTC market for better regulations. Committee on Payments and Settlement Systems and the International Organization of Securities Commissions ("CPSS-IOSCO", 2012) established the guidelines for Centralized Counterparty and reporting for few OTC derivative instruments. GAAP and IFRS have also made an effort to bring reporting under both the methods in line and bring more transparency into accounting statements.

Regulations - A Boon or Bane

While the Global Financial Crisis of 2007-08 was primarily attributed to the failure of regulations but we still have this debate going on globally among bankers, regulators, politicians, and economists on the extent of regulations and their impact on the long run. When it comes to financial markets regulations, have an essential place. Asymmetry of information distribution profoundly drives financial markets. There are a small group of people with knowledge and expertise in understanding the sophisticated instruments and risk associated with them. If not regulated these people may fall into greed and manipulate the market. Also, the incentive structure in most of the institutions promotes in generating short-term profit while shielding against any loss this often leads to people doing wrongdoing to show inflated numbers in books or manipulating markets to short-term trends. There is a definite need of regulation to have proper oversight over activities of institution and individual and make people in power answerable in case of any wrongdoing.

At the same time regulators, themselves need to have a broad vision while implementing any regulations. They need to understand and study the entire market as a whole and try to explore its long-term impact on bodies both directly and indirectly falling under the jurisdiction of such regulation. In the past with increasing influence of politicians and significant lobbying by financial institutions themselves, it's legitimate to doubt that the regulators have or could bring to the table such regulations with a holistic view. Under such a scenario, these regulations at times end of setting a stage for another disaster instead of controlling them.

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