Point Park University

# The Meltdown of the Great Recession

Homework 2

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**Introduction**

In the contents of this paper, the main point we are going to analyze is the 2009 Great Recession in the United States. We are going to use the film documentary “Inside The Meltdown” presented by Frontline. The paper has four parts. The first part of the paper is the executive summary which will give you an overview of the film. The second part is based on follow-up questions of the film, such as important ideas, recommendations to our current government, etc. The third part of the research paper is the graph section. The graph will show the number of bank failures in each of the years in the period 2006-2020. Part 4 will be an analysis of a recent news article about the US banking system. Finally, an introduction will recap all of the important points and topics covered in the paper.

**Part 1: Executive Summary**

The financial crisis that occurred between 2008 and 2009 is a good example of the consequences of unethical business practices in the corporate world. Essential financial strategies are critical to an organization's performance. Any management must consider ethical measures to ensure that the ideologies implemented in any corporate practice are worthwhile. Michael Kirk's film Frontline: Inside the Meltdown attempts to explain the events that led to the fall of major corporations such as Lehmann Brothers, Bear Stearns, AIG, etc. This is an event that we must learn from and by all means, something we cannot repeat.

The documentary starts On Thursday, September 18, 2008. In a scene where the chairman of the Federal Reserve told the astonished leadership of the United States Congress in a private session that the American economy was in grave danger of collapsing within days. They went to Nancy Pelosi's office on Thursday late afternoon for a meeting of senior legislators from both parties in the House and Senate. They had bailed out one bank and allowed another to fail in the previous seven months, nationalized three of the country's largest corporations, and watched in horror as the credit markets froze. They sat in that room, and Hank Paulson stated calmly, without hyperbole or exaggeration, that "unless you act, the financial system of this country and the world will meltdown in a matter of days." Bernanke said, "If we don't do this tomorrow, we won't have an economy on Monday." (Frontline)

Prior to that day of meltdown in the spring of 2008, the real estate bubble had burst. Just two years ago, home prices were at an all-time high. Wall Street had bet heavily on mortgages, particularly risky ones. Existing-home sales fell 8.6 percent in the previous month. Fear crept in as the housing market crashed. In December, there were 303,410 foreclosure filings in the United States. Wall Street was fearful of a financial meltdown due to shaky home mortgages. Then, on Monday, March 10, a rumor about Bear Stearns was leaked, claiming that they were running out of cash and could be in big trouble.

The rumors about Bear revolved around its massive investments in subprime mortgages, which became known as "toxic assets." They made a lot of money from mortgages. They were big on packaging them and making securities out of them, as well as purchasing them. The more the housing market expanded, the more Bear and other investment banks purchased. Accelerating housing prices instilled in everyone involved in the mortgage industry, from the buyer of the house to the broker, the mortgage broker, the bank, and Wall Street, the belief that housing prices could only rise. That was until 2007 when everything changed. In what is known as the repo market, Bear Stearns rolled over its loans every night or every few nights. And this gave its lenders the option, each night, to call in some of their loans or demand more collateral. This effectively means that investment banks face a vote of confidence every night to determine whether or not they will survive. And by that evening, the markets had voted against Bear Stearns. On Thursday, Bear's stock fell further, and the reserve was nearly depleted. By 6:00 p.m., it's clear that they didn't have enough money to open the following day. They had hours to do something unprecedented in terms of emergency capital raising or they will go bankrupt. They had one last chance, and it was at the Federal Reserve Bank of New York.

Tim Geithner was in charge of the Fed at the time. Geithner's team went to Bear's headquarters and began going through all of the accounts. Within hours, Morgan, the Fed, the SEC, and plenty of other organizations and banks were examining all of Bear's information. Unfortunately, they discover that Bear has been stuffed with toxic waste. The problem was that Bear's was associated will all of the other banks and lenders on Wall Street. So as soon as they fall, all of the others will be dragged down with them. Knowing this the Fed knew that the risk to the financial economy would be catastrophic if they allowed Bear Stearns to go bankrupt. The problem they faced was that the Federal Reserve was prohibited from directly lending cash to Bear, an unregulated investment bank. Bernanke was prepared to get around the rules, and he did.  They eventually came up with this idea of giving a loan to JPMorgan, which was Bear's clearing bank, and having JPMorgan pass on the cash to Bear, so indirectly lending to them via JPMorgan. But Bernanke's unprecedented plan almost immediately backfired. When the stock market opened that morning after the announcement Bears stock decreased by over 50% hitting $30 per share. In 7 days Bear Stearns was gone.

Toxic mortgages continued to eat away at every major Wall Street firm throughout the summer of 2008. The Dow dropped 240 points, while the NASDAQ dropped 46 points. Shares of the mortgage giants Fannie Mae and Freddie Mac were being sold off by nervous investors. The next financial crisis would not occur on Wall Street, but rather at Fannie Mae and Freddie Mac, the world's largest mortgage lenders. These are also massive corporations. Every institutional investor owns Fannie Mae and Freddie Mac stock and even more of their debt. Their failure would mean systemic risk for all of the financial system. To fix this the Fed determined that it was necessary to nationalize this firm by firing all the management and taking over day-to-day operations to keep them afloat and not cause a meltdown.

This was not the case for Lehman, the government did not intervene and made them fail and claim bankruptcy. The Fed and Treasury believed that Lehman could fail without causing a major conflagration. It would be a significant event, but it would not result in a cataclysm. This turned out to be incorrect. The stock market dropped by hundreds of points right from the open. Paulson had underestimated the extent to which Lehman Brothers was interconnected. Systemic risk had now become a reality. Banks ceased lending, The credit markets froze.

With the credit markets frozen, there was soon a new big company at risk, AIG. This was the world's largest insurance company. It had invested tens of billions of dollars in risky investments linked to the housing market. AIG did not have enough money in the bank to back up the promises it made. AIG had sold unregulated credit default swaps worth tens of billions of dollars, insurance policies based on the bet that companies like Lehman Brothers would never go bankrupt. The unthinkable had occurred. Lehman Brothers had gone bankrupt. AIG needed $100 billion in cash by the end of the night or they would have to announce bankruptcy and with the credit-markets frozen no one was able to lend them the money. Paulson and Bernanke were their only hope at staying afloat. After discussing and knowing they had let other companies go under they were under the impression that they needed to save AIG or it would be catastrophic to the economy even more. Bernanke lent AIG $85 billion. The United States government now controlled the world's largest insurance company, an 80% stake of ownership.

There's a limit to what the Federal Reserve can do. Many people believed they have gone beyond the normal limits of what a central bank should do. So, Bernanke told the Republican secretary of the Treasury they needed to initiate a full-scale bail-out of the nation's financial system. The next day, Paulson and Bernanke headed to Capitol Hill for that meeting with the congressional leadership. His plan was a $700 billion request to be used to buy the kinds of toxic mortgage securities that were creating so many problems for the banks. On September 29th, the House of Representatives voted on the bill. The

House Republicans, who had initially voiced support for the bail-out package, pulled their support. The bill was unable to pass with 95 democrats also siding with the republicans. The DOW dropped a historical 777 points. Though by the end of the week under intense pressure, a revised bill finally cleared the House.

Then, on October 12th, something extraordinary happened. Paulson personally called the CEOs of the nation's nine largest banks and invited them to his office in the Treasury building the following day. The FDIC's Sheila Bair was present. According to Paulson, the entire banking system is in serious trouble. Paulson spent $125 billion that day to relieve economic pressures and spent an additional $350 billion to save the financial system altogether. It was now on Barack Obama to somehow save the banks and the whole United States economy.

**Part 2: Follow-Up Questions**

Q1) Three Most Important Ideas:

1. Anyone Can Fail

The notion that global banks were "too big to fail" was also used by lawmakers and Federal Reserve governors to justify bailing them out to avert a global catastrophe that could have been several times worse than the crisis itself. Even though AIG was the largest insurance agency in the world it eventually needed to be bought out by the federal government for 80 billion dollars during the financial crisis.

2. The Power of The Fed

It is shown how much influence our federal government has on us, especially the Federal Reserve. During the Great Recession, the Fed was able to approve funds to bail out the banks. To address the financial crisis, the government spent $1.2 trillion on purchasing various financial assets and making emergency loans, far exceeding the $700 billion authorized by Congress from the federal budget. The Fed was doing this to bail out the banks and prevent some of the largest banks and corporations in the world from going bankrupt

3. Greed Doesn't Win

Pre-Recession greedy Banks cut corners and made false claims on applications, but the loans were good at the time.  Back in 2007, housing prices were rapidly rising. So, in the worst-case scenario, if someone is unable to pay their mortgage, they simply sell their home and pay off the mortgage. It's a good loan because the bank makes money. Alternatively, they obtain a home equity loan and pay for it that way. Suddenly, housing prices stopped rising, and people were forced to pay their mortgages and other expenses solely from their earnings, rather than from the equity in their home These loans were now bad because the borrowers were unable to pay their mortgages.

Q2a) Causes of the Great Recession:

1. Housing Bubble

Home prices were at an all-time high during the housing bubble. Wall Street had bet on mortgages, particularly risky ones. In the previous month, existing-home sales fell 8.6 percent. As the housing market crashed, fear crept in. There were 303,410 foreclosure filings in the United States in December. Wall Street was concerned about a financial meltdown caused by shaky home mortgages. As a result, banks were unable to repay their mortgages and were forced to be bailed out by the federal government.

2. Bad Loans

In the decade leading up to 2007, real estate and property values had steadily increased, encouraging people to invest in real estate and purchase homes. The residential housing market was booming by the early to mid-2000s. To take advantage of the boom, mortgage lenders rushed to approve as many home loans as possible, including to borrowers with less-than-ideal credit. Many homebuyers took out loans without understanding the risks involved to take advantage of a hot market and low-interest rates. However, conventional wisdom held that subprime loans were safe because real estate prices were bound to rise further.

3. Unethical Wall Street Practices

Another reason banks on Wall Steet went bankrupt was because of the unethical practices they were involved in. For example, Bear Stearns not only had billions in hidden subprime mortgage loans but also had credit default swaps. This is a form of insurance where it is an agreement that they sell someone insurance on a bond that you own. If the bond does not pay then Bears would have to pay you. As long as the bond does not go belly up they pass Bears for selling insurance to you. Bears had made credit default swaps on delts worth hundreds of billions of dollars all over Wall Street.

Q2b) Changes in Regulation and Supervision - Dodd-Frank Act

1. The Financial Stability Oversight Council (FSOC)

The Financial Stability Oversight Council (FSOC) is in charge of ensuring that banks and other financial institutions do not become "too big to fail." One of the causes of the 2008 financial crisis was the fact that a few financial firms had grown so large and important to the functioning of the financial system that the United States government was forced to save them from their own bad decisions. Dodd-Frank provided the FSOC with powerful tools to prevent any single firm from growing to be this large or important to the economy. The council, which consists of the Treasury Department and Federal Reserve officials who are advised by industry experts and academics, is tasked with identifying threats to financial stability. But perhaps its most powerful tool is the ability to impose stringent regulations on, and even break up, firms that pose significant risks to the economy. (Forbes)

2. Banking Industry Stress Test

Dodd-Frank required the Federal Reserve to keep a closer eye on the country's largest banks and financial institutions, including giant insurance companies. The act mandated special annual tests to ensure that these massive financial institutions were ready for the inevitable arrival of recessions and future financial crises. These so-called stress tests employ hypothetical scenarios to evaluate the impact of various financial shocks on their stability. If a bank does not have enough capital on hand in certain scenarios, the Fed can suspend share buybacks or cap dividends to ensure the bank is strong enough to lend to struggling businesses and weather economic downturns. (Forbes)

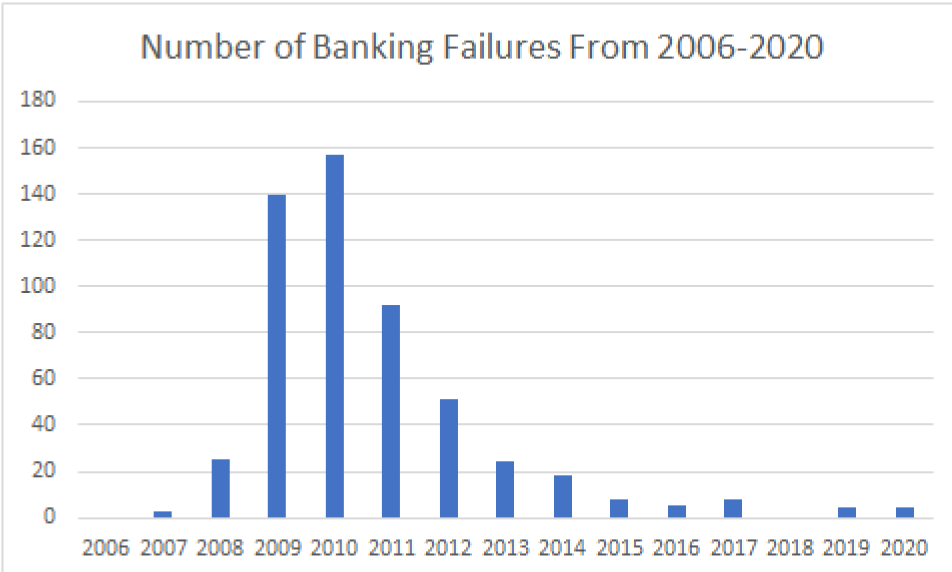
2. The Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau is the most visible and well-known of the new regulatory bodies established by Dodd-Frank (CFPB). The Consumer Financial Protection Bureau's mission is to protect consumers from risky or abusive financial products. The bureau has the authority to regulate companies that sell financial products to consumers and to enforce anti-discrimination laws in consumer finance. As the financial services industry deregulated in the decades preceding the crisis, an increasing number of financial products were marketed and sold to consumers with little oversight by legacy financial industry regulators. The rules governing credit reporting agencies, payday lenders, consumer loans, student loans, and banking fees were ambiguous, and consumers were frequently sold expensive, risky products that they did not fully comprehend. (Forbes)

Q2c) Opinion on bank bail-out

It was a tough situation but no I do not believe that the banks should have been bailed out by the government during the great recession. I believe this because the banks were at fault, not an outside source that is unpreventable. They knew that they were using unethical methods to try to make as much money as possible not realizing the risk because they always believed that they were “too big to fail.” Banks were lending and giving high mortgages to people they KNEW could not afford them. But they had no problem giving them out because they knew with housing prices rising they could always sell the house again and make a profit for themselves.

**Part 3: Bank Failure Graph**




Q1) Comment on graph

It is clear from the graph that there is a direct correlation between the number of banking failures and the time in which the great recession took place. The main reason for the bank failures during the time of the great recession was because they were unable to pay the mortgages that they gave out to lenders. They then had no money left and had to be bailed out resulting in failure.

**Part 4: Recent Article**

Title: JPMorgan Renews $146K Bitcoin Price Prediction

JPMorgan released the first report in its new publication, which focuses on the outlook for alternative investments, including digital assets. Every two to three months, a new report will be released. According to the firm's analyst Nikolaos Panigirtzoglou, bitcoin's long-term price could reach $146K, with a short-term price target of $73,000 for 2022. Panigirtzoglou expects bitcoin's competition with gold to continue, especially as more millennials invest, given their preference for cryptocurrencies. "Considering how big the financial investment into gold is, any such crowding out of gold as an 'alternative' currency implies big upside for bitcoin over the long term," he detailed. Though, Panigirtzoglou said that bitcoin is wildly unpredictable and a surge above $146,000 and a plunge to below $30,000 are both possible. I guess only time will tell

**Conclusion**

The 2008-2009 financial crisis is a good example of the consequences of unethical business practices in the corporate world. Essential financial strategies are critical to the success of any organization. To ensure that the ideologies implemented in any corporate practice are worthwhile, any management must consider ethical measures. Luckily for these banks, the government was able to pass the legislature and distribute the billions of dollars needed for these banks just to stay afloat during this time. The recession is a grave reminder that for any practice, not just thanks, you are never too big to fail.

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