

The Global Financial Crisis: Roots and the Fruits

Shailesh Kumar

Skepticism ruled Federal Reserve Chairman Ben Bernanke's FedSpeak when he declared on October 16, "Stabilization of the financial markets is a critical first step, but even if they stabilize as we hope they will, broader economic recovery will not happen right away." Last month's fear of a looming recession led to the biggest drop in the stock market since the 1987 crash, as retail sales fell and demand for commodities plummeted. Experts speculate that the U.S. economy might be poised for the deepest recession since the Great Depression.

It is obvious that subprime mortgages are at the root of the present crisis. Yet, the issue is much more complicated. Mid-18th century economist Adam Smith advocated a free market approach to the economy, contending that if players act in their self-interest an *invisible hand* will self-regulate the market to prevent crisis. Previous U.S. presidential administrations had great faith in this doctrine, which led to broad deregulation in the financial markets. As we are now seeing, however, over-reliance on self-regulatory capability of the markets is the actual cause for the current breakdown.

Letting the banks do what they want

The stage for the present crisis was set decades ago. Stock trading commissions were deregulated in the 1970s. The Glass-Steagall Act of 1933, which defined the distinction between investment and commercial banks, was repealed in 1999. This deregulation allowed other financial institutions to enter the territory of investment banks by trading stocks. Investment banks also sought refuge in the riskier business of securitization and high leverage (borrowed money). The Securities and Exchange Commission further relaxed the rules for investment banks in 2004, leaving them to essentially regulate themselves.

House prices never fall

Lower interest rates led to recovery from the 2001 recession, but the Federal Reserve kept interest rates too low for far too long, even when insiders started complaining. The generous credit environment prompted high levels of home equity borrowing funded by a new generation of "creative" mortgage companies. These companies function like hedge funds and exist beyond the regulatory radar. This fueled a speculative spree in the housing market with consumers understanding little of the risk involved in these mortgages. With low interest rates and a lack of regulation, loans began to be offered to subprime borrowers (less credit worthy borrowers) at a higher rate. To lure borrowers, the lenders offered teaser rates, which are lower in the beginning but grow rapidly.

The financial wizards

Financial institutions on Wall Street, through a process called securitization, pooled the subprime mortgages and structured them into bond-like securities. They were sold to investors, transferring the risk to them. The money raised was used to finance further subprime mortgages. As the securities became more complex, they became harder to value, further increasing their risk. One way to signal the high quality of these securities is to obtain a favorable rating from credit rating agencies. The rating

agencies inaccurately rated these securities as investment grade. The inaccurate assessment of risk by rating agencies can be attributed to both methodological errors and a conflict of interest between the originators of these securities and the rating agencies, which were paid by the originators of the securities they were evaluating.

Major banks set up Structured Investment Vehicles (SIV) to borrow short-term and lend long-term for housing. Some banks borrowed 30 times the amount of their own funds. The lenders felt safe, reasoning that in the event of a default, they would foreclose on the mortgaged property and recover much of the loan. The financial institutions also hedged against default by investing in credit derivatives, or Credit Default Swap (CDS). Eventually, as the repayment amounts of the teaser loans rose, the subprime borrowers began to default.

The bubble bursts

The confidence in the housing market did not endure so housing prices began to fall. The position of homeowners became untenable. Borrowers were now defaulting not only due to their inability to pay but also their unwillingness to pay, as their houses were worth less than their mortgage. Appearance of a large number of houses for foreclosure caused housing prices to tumble further. With delinquent loans and houses worth far less, the lenders' assets deteriorated. By now the subprime mortgage-backed securities were held globally. Investors started withdrawing from lenders. The banks started incurring losses in the derivatives market on their CDS, which existed to provide hedge protection. Banks in U.S., Europe and Asia collapsed. The two remaining investment banks in the U.S., Goldman Sachs and Morgan Stanley, converted to commercial banks, a status subject to more regulation but with readier access to capital. Wall Street, as was formerly understood, is practically dead.

But Main Street is not insulated from this havoc. These bad assets are now held by all kinds of institutions, ranging from the biggest banks to local government investment pools. No one can estimate the exact amount of losses and who incurred them, but they are huge and will have far reaching effects. Therefore, the \$700 billion bailout plan by Treasury Secretary Henry Paulson might just be a shot in the dark.

The failure of the *Invisible Hand*

The policies of little regulatory oversight were based on the premise that the mortgage companies and investment banks will act in their self interest to protect their shareholders. However, the short-term interests of the managers in mortgage companies were to give out more sub-prime loans quickly. With the instrument of securitization the burden was shifted to other investors, which prompted the lenders to take more risks. It was believed that the investment banks would act in a disciplined way for self-preservation and responsibility and not borrow excessively. But self-regulation rarely works this way.

Financial derivatives evolved as a mechanism to limit risk, but they only helped transfer the risk. Even those who were not willing to take risk are now affected, as it spread throughout the financial system. Experts like Warren Buffet and Felix Rohatyn were always wary of derivatives, equating them to bombs. However, former Federal Reserve Chairman Alan Greenspan, in power during much of the deregulatory period, fiercely opposed tighter regulation of derivatives whenever they came under scrutiny. Greenspan himself admitted in testimony to Congress on October 23 that more

regulation is needed to prevent further disaster. Yet, his realization comes much too late. Without adequate institutional regulation the market will fail to curb the “opportunism” of the players. Even if the market does affect self-correction, it might take too long. As we are seeing, a crisis has already precipitated.

Conclusion: what's next?

It is clear that regulators did too little to control the situation. A number of economists warned of a speculative bubble in the housing market as prices skyrocketed. However, Greenspan brushed aside all fears on the belief that housing prices have never gone down. Congress passed the Home Owner Equity Protection Act of 1994, requiring certain disclosures from lenders and placing restrictions on them. It gave the Fed the power to frame and modify regulations. This was another opportunity for the Fed to curb deceptive lending, but it took no initiative.

The present financial crisis became visible in June 2007 when Bear Stearns announced that two of its hedge funds were in peril. But the government failed to develop any plan to prevent further damage. The SEC allocated too few resources to monitor the investment banks, instead relying on the banks' own computer models to assess risk. The hedge funds remain largely unregulated because they deal with the wealthy's money, who are expected to take care of their risks. However, these hedge funds borrow from all banks, creating the possibility of a systemic risk in the case of a counterparty default. Whenever there is a crisis there is a cry for stricter regulation. The proper course is not simply stricter regulation but instead proper regulation. Investment banks, though under the purview of the SEC, were allowed to pile up debt without setting aside reserves for default risk. Since the market perceives them as regulated by a government agency, it underestimates their riskiness. Similarly, the government-backed Fannie Mae and Freddie Mac existed without regulation. The association of the government gave the investors a false sense of security and they bought their products with no perception of risk.

Half-hearted regulation does not help. The financial system has become so integrated and complex that it will be unwise to allow any one type of institution to pursue riskier strategies. The timing of intervention is equally important. The present financial crisis has been simmering for more than a year while the authorities just watched with fingers crossed. The derivatives market warrants some oversight. The leverage and reserve requirements have to be restated judiciously. The government has to figure out ways to value the troubled assets. Above all, efforts have to be made not only to restore liquidity in the financial markets, but address the underlying cause - the problem of homeowners and how to inspire confidence in the market.

Suggested Further Readings:

Andrews, Edmund L. *Greenspan Concedes Error on Regulation*, New York Times, October 23, 2008, Business Section,
<http://www.nytimes.com/2008/10/24/business/economy/24panel.html?hp>.
Eichengreen, Barry. *Anatomy of financial crisis*, 23 September, 2008, VOX,
<http://www.voxeu.org/index.php?q=node/1684>.

- Getter, Darryl E., Mark Jickling, Marc Labonte, and Edward V. Murphy, September 21, 2007, *Financial Crisis? The Liquidity Crunch of August 2007*, CRS Report for Congress.
- Goodman, Peter S. *Taking Hard New Look at a Greenspan Legacy*, October 8, 2008, <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html>.
- Krugman, Paul. *Innovating Our Way to Financial Crisis*, December 3, 2007, Economist's View: <http://economistsview.typepad.com/economistsview/2007/12/paul-krugman-in.html>
- Krugman, Paul. Kellogg School Lecture, October 27, 2008, http://www.kellogg.northwestern.edu/News_Articles/2008/Paul_Krugman.aspx
- Satow, Julie. *Ex-SEC Official Blames Agency for Blow-Up of Broker-Dealers*, The New York Sun, September 18, 2008, www.nysun.com/business/ex-sec-official-blames-agency-for-blow-up/86130/.