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Fakten für eine faire Arbeitswelt.

ETUI Seminar 08-12-2008
The economic and financial crisis: Elements to construct a new paradigm

Financial market innovations and lack of regulation as causes of the financial market crisis

Lothar Kamp - Hans Böckler Foundation

Main causes of the financial market crisis

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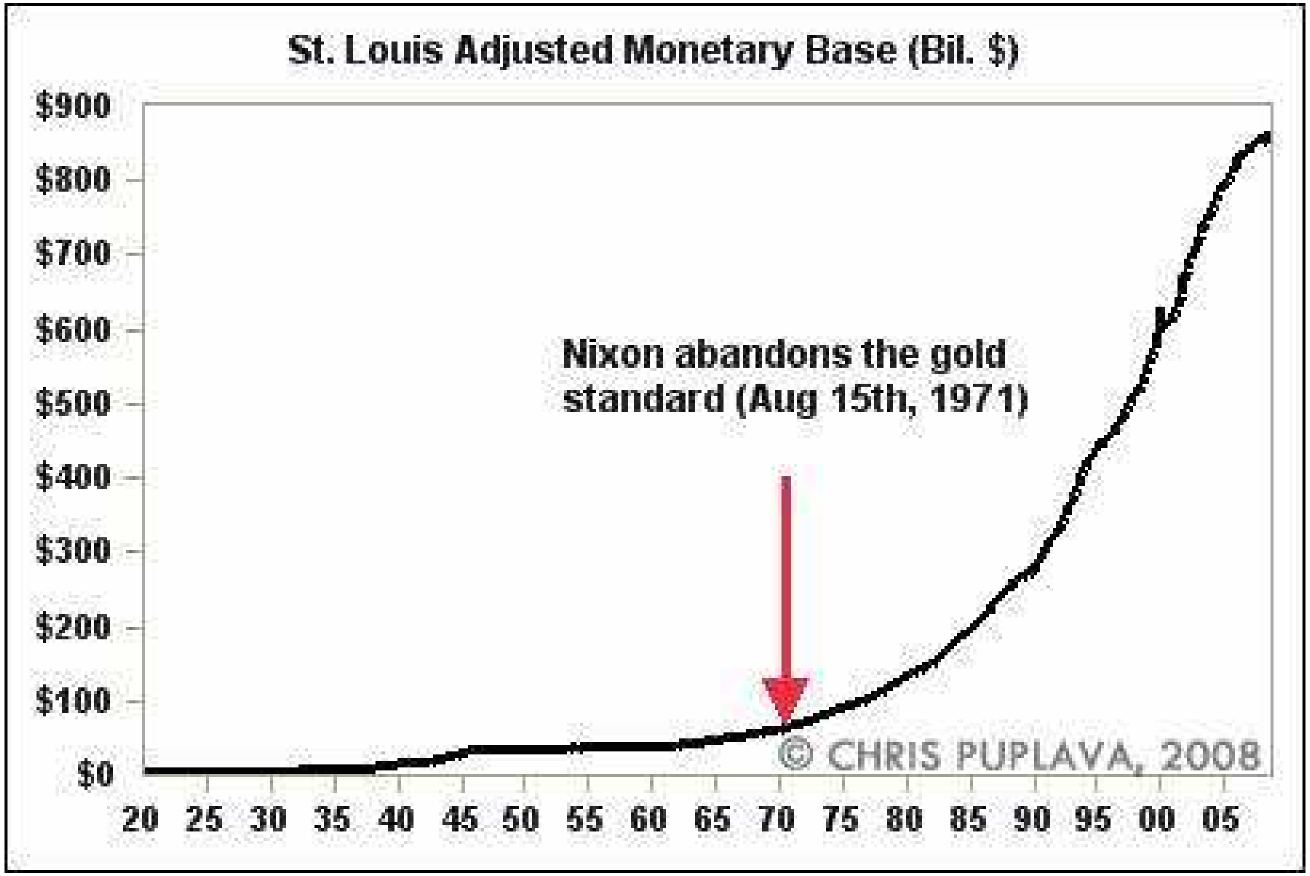
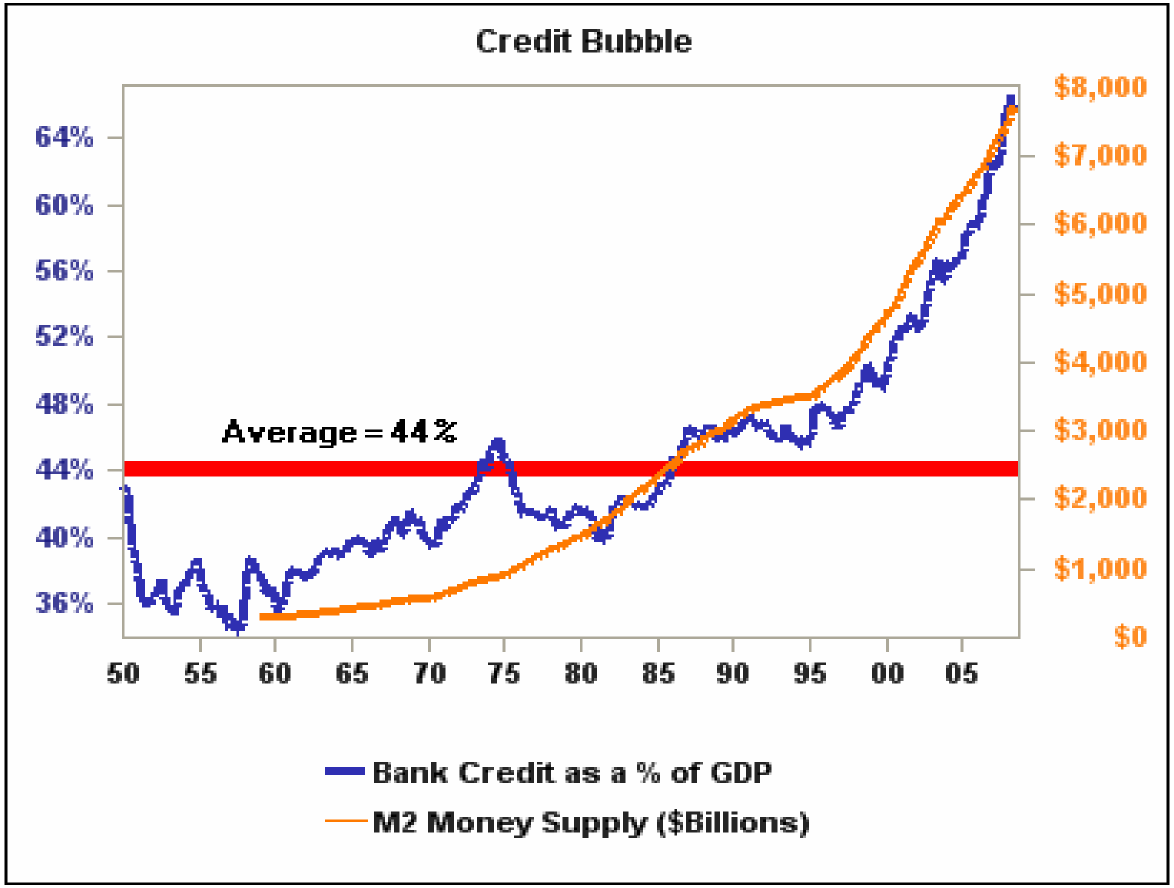
- 3 main causes of the financial crisis
  - Central banks maintain low interest rates in times where liquidity is higher than ever (especially USA)
  - „Application“ of the high liquidity in the credit markets
  - Rampant mismanagement on loan markets in the absence of regulation of financial innovations

Money supply explosion after Bretton Woods



Money supply explodes after breakdown of the Bretton Woods system.

Surge of money supply and credits



Parallel surge of money supply and credit expansion

High leverage and speculation bubbles

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- After the abolition of the gold standard, fixed exchange rates and capital export restrictions, globalization develops - strongly driven by the financial markets
- Since then the intervals between speculation bubbles have become shorter and shorter
- Financial institutions tend to strongly increase leverage when market interest rates are low (the lower the interest, the higher the return on equity, the greater the propensity to increase leverage)

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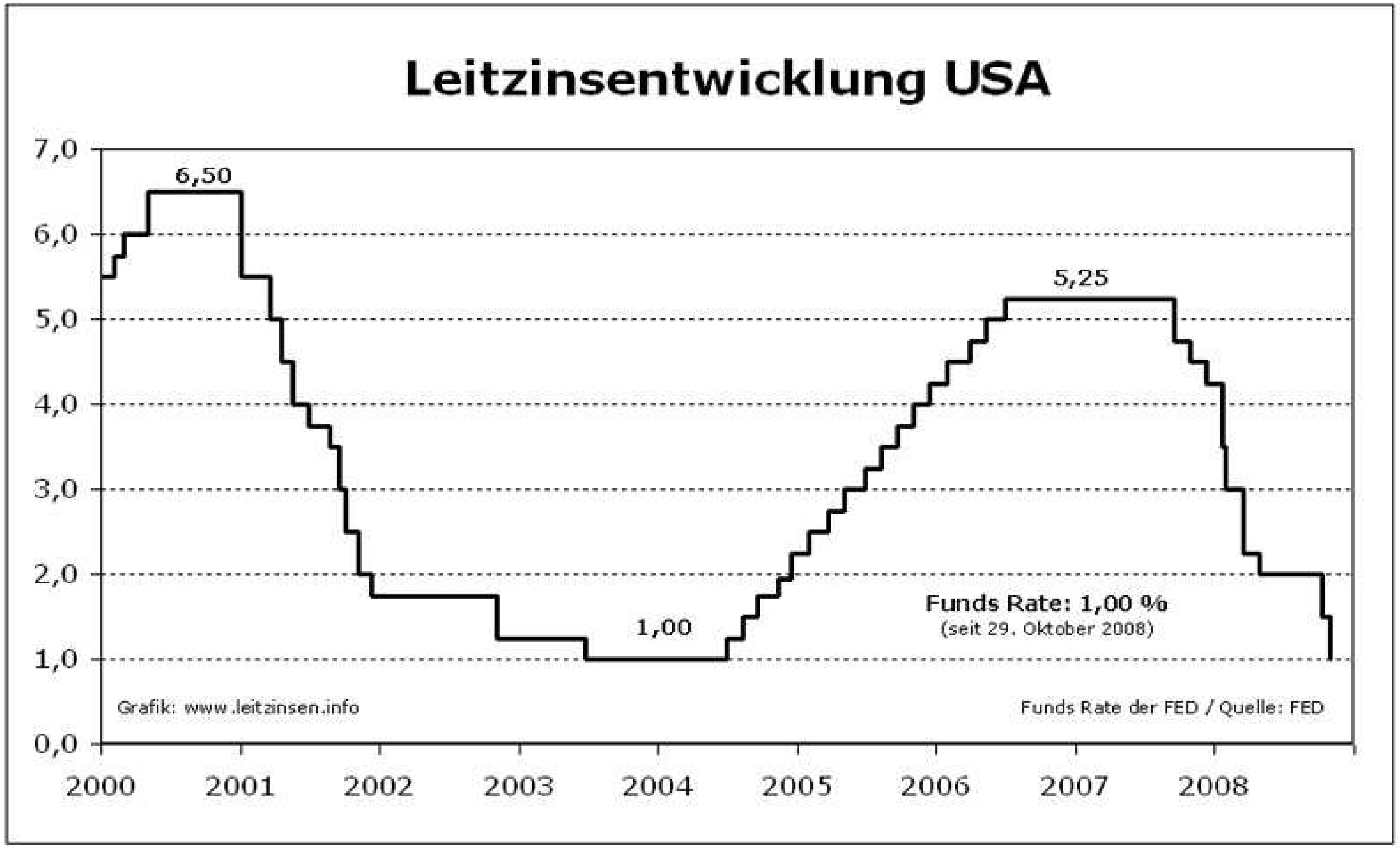
Credit surge – negative savings rate

- Credit use expands massively due to higher leverage, and latent risks rise
- Central banks tend to respond to crises by increasing liquidity without reducing it again
- In 2003/2004: The real interest rate in the US is negative: Being highly indebted makes more sense than to save money; for the first time in history, the US has a negative savings rate

Too low base rates of FED



Negative real interest rate in 2003-05

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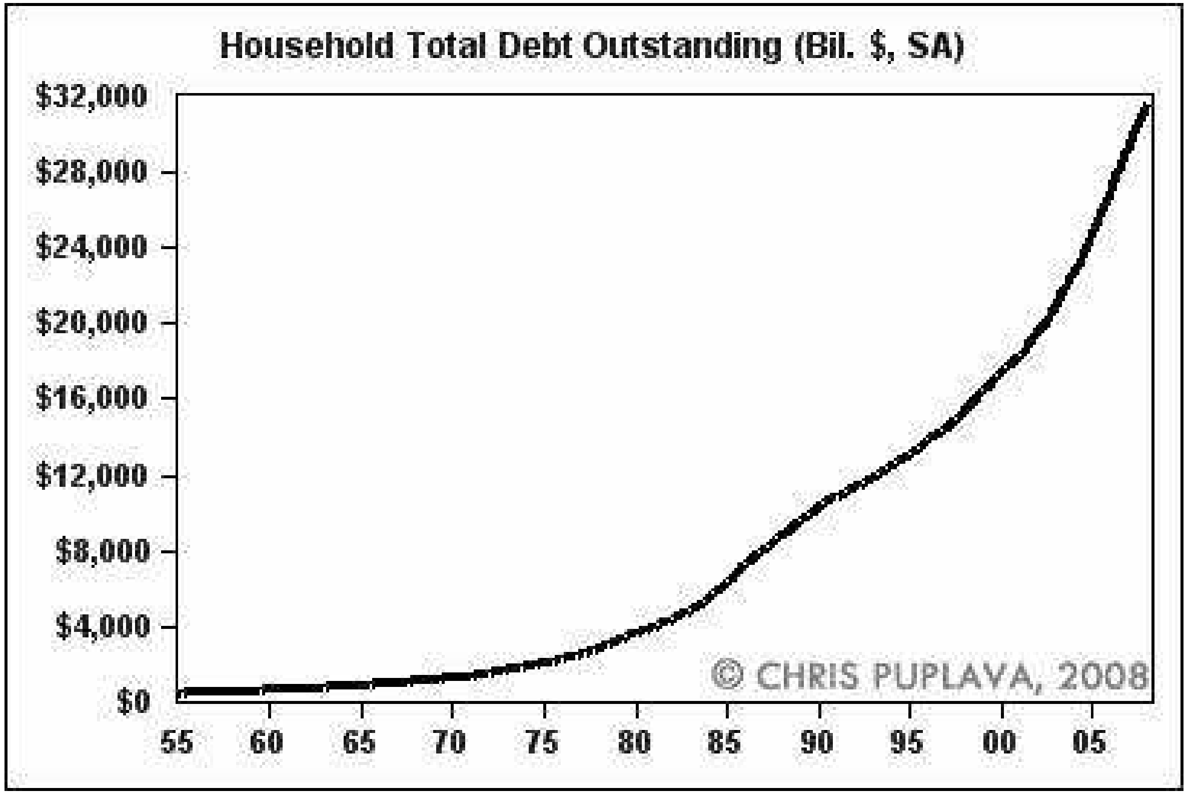
The risks seem away

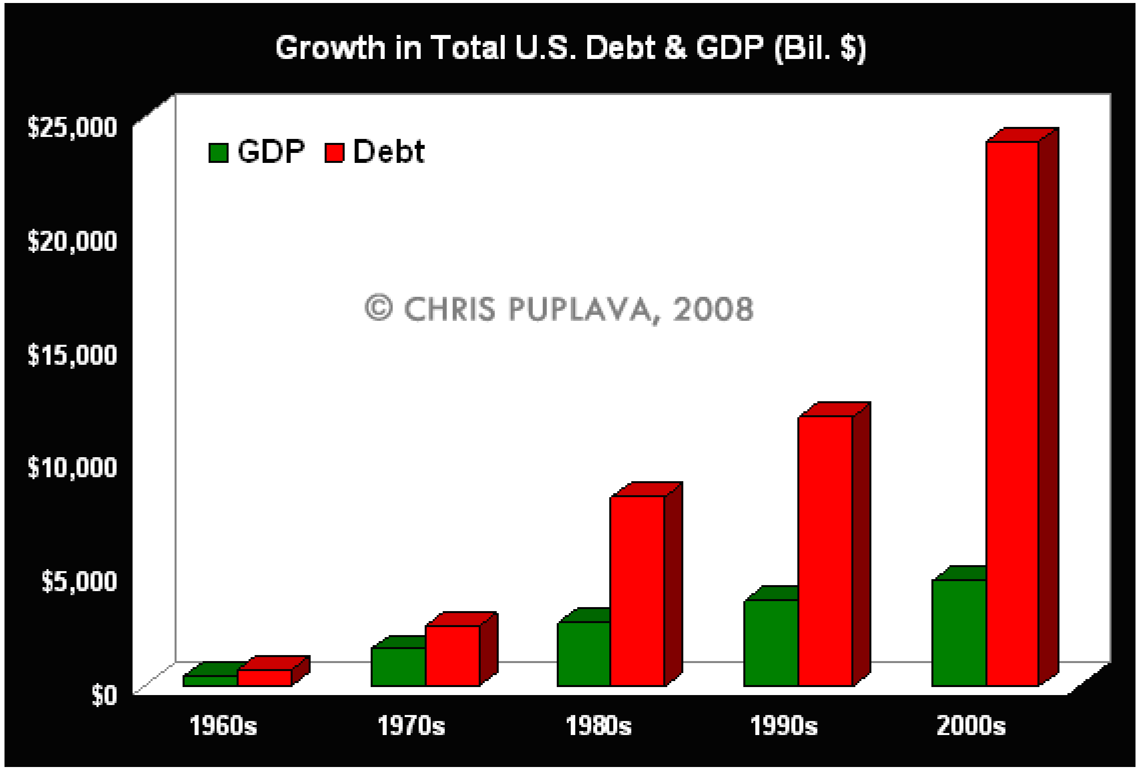
- When liquidity is high and loan loss rates are low, spreads are extremely low and ratings extremely good. Banks are more likely to engage in risky business, and the loan market heats up.
- Market players believe that the risks of the past are now fully under control thanks to modern financial instruments

Household debts increase



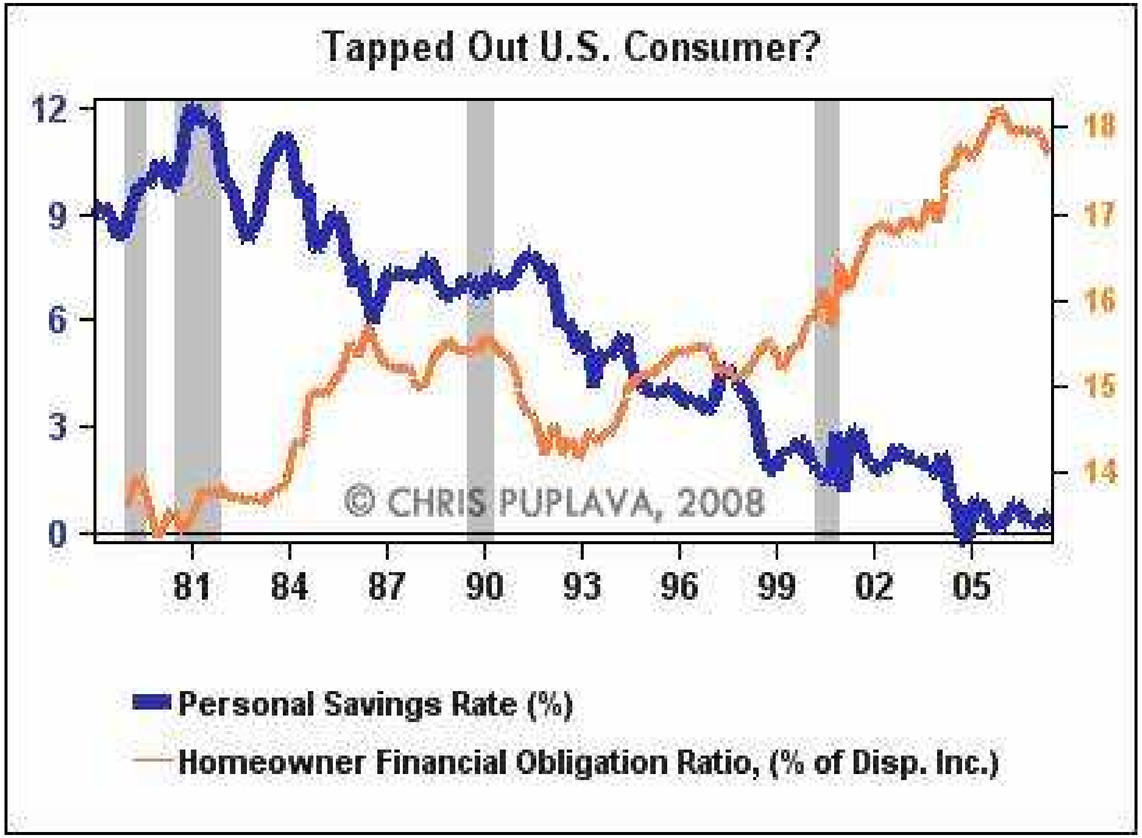
Progressive growth in household indebtedness since the 80s

Credit go apart from the real economy



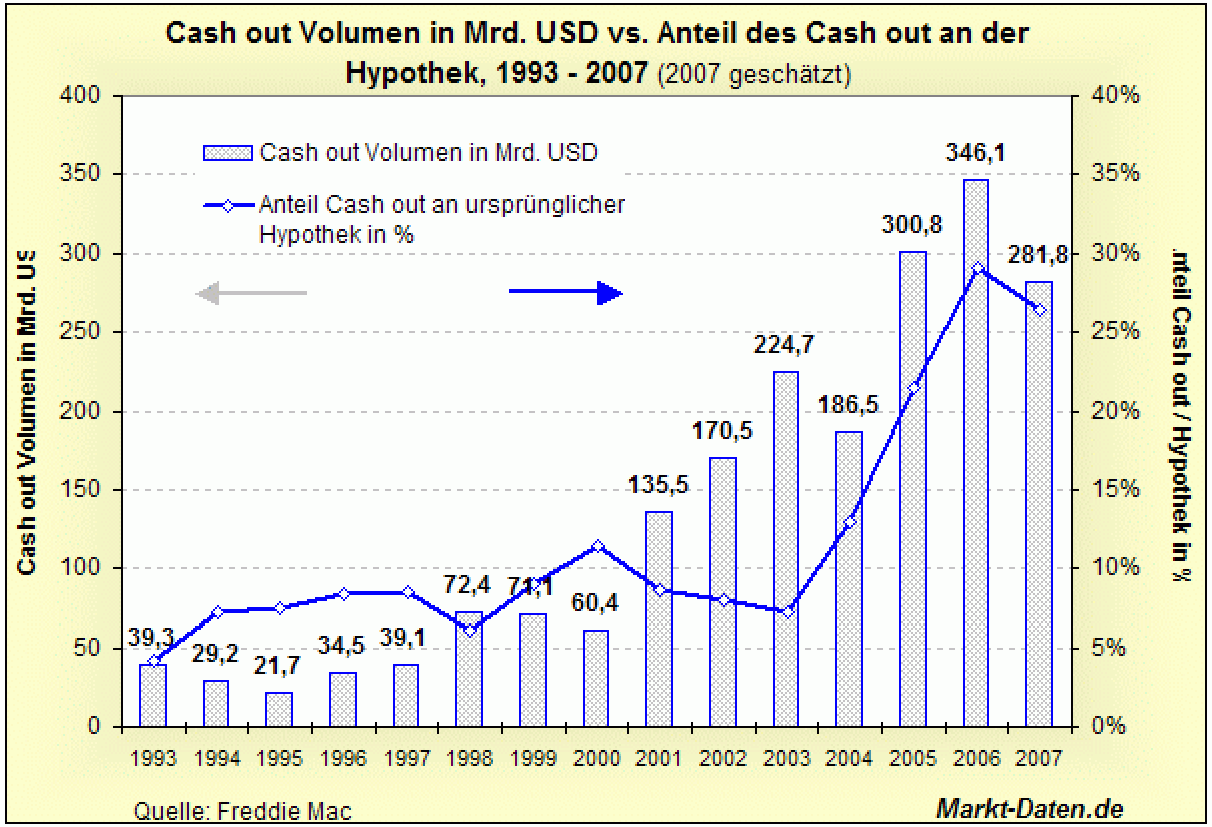
Whereas the total US debt more or less equalled US GDP in the 1960s, it has grown several times over since then

Less savings – more mortgage



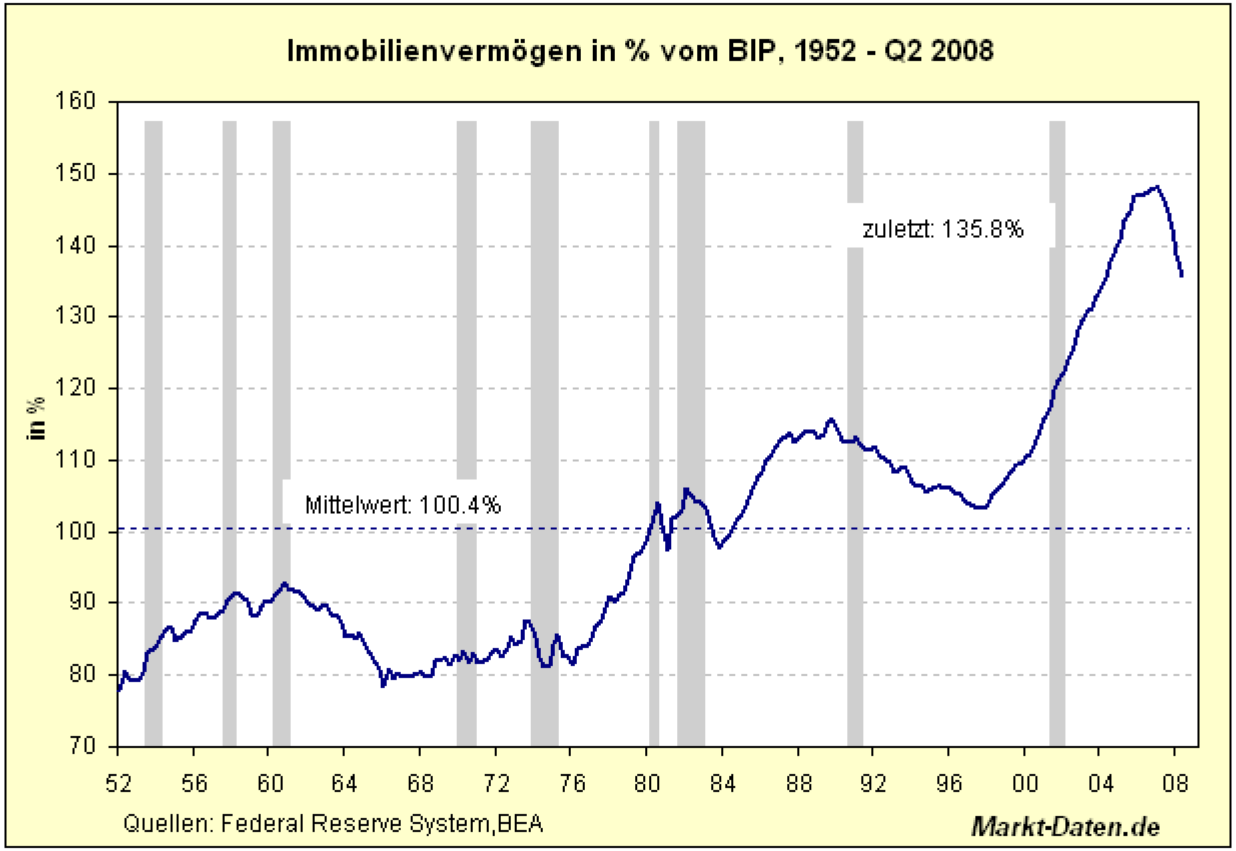
Personal savings rate and mortgage drifting apart

Cash out of homes for consumption



Heavy borrowing against the value of homes to finance consumption

Big importance of real estate in US



Surge in real estate assets as a percentage of GDP since 1997

The spread of derivatives

- Since the 80s increasing acceleration in the development of innovative financial instruments that are completely out of touch with the real economy. In addition, they are highly risky, abstract, complex and opaque: Futures, Options, Swaps, ABSs, CDOs, CDSs, $CDOs^2$, SIVs / Conduits
- The worldwide volume of credit derivatives has risen massively in the current decade: from $142 trillion in 2002 to $596 trillion in the end of 2007, $60 trillion of which are accounted for by CDSs (Source: The Economist)

Lack of regulation and systemic risks

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- Lack of regulation of hedge funds, private equity funds, SIVs and conduits, these businesses form a kind of "realm of shades" as they are not transparent to the markets and in the banks' reporting systems or balance sheets
- Gigantic financial conglomerates that emerge especially in Anglo-Saxon countries become a systemic risk each
- US investment banks are not a part of the regulated banking system. They are not subject to regulatory capital requirements. Work with extreme leverage of up to 1:20.
- Lack of regulatory response to and supervision structures for innovative financial instruments both on the national and the international levels, often for ideological reasons: "Markets regulate themselves, the government should not intervene."

State promoting of home ownership – spreading mismanagement

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- US government’s policy actively promotes high household and corporate debt levels ("everybody should own a home“, state support for mortgage giants Fannie Mae and Freddie Mac)
- Huge mismanagement in the mortgage sector: Initial interest below inflation rate or zero; debtors with zero or little equity; mortgage volume larger than the real estate value; mortages granted to debtors with troubled credit histories; mortgages provided without submission of relevant documents or audit of the debtor’s income situation or financial standing; no or “doctored” home appraisals

Banks' engagement in subprime

- Three essential reasons for banks to engage in subprime business
  - High returns
  - Rising house prices reduce risk for banks
  - What is most important: Thanks to securitization, banks can eliminate subprime loans from their balance sheets almost completely; hence, they do no longer carry the high risk

Markets are reliant on asset price rising

- As long as asset prices were rising, the markets work well: There is no risk for the banks, because a house after foreclosure is always worth more than before. In addition rising house values encourage heavy consumer borrowing.
- But: markets are now organized such that they won’t work **unless** asset prices rise

Moral hazard of consumers

- Moral Hazard among consumers is encouraged:
  - US mortages often are "no-recourse loans": foreclosing lenders cannot go after other assets than the house -> borrowers encouraged to just to stop the payments and leave the house
  - When credit card holders exceed their limit the only thing they need to do is take out another credit card; Many people in the US have 10-15 credit cards with debts clearly exceeding their future solvency
- There is no appropriate response to the rampant mismanagement on credit markets

Banks as a problem (1)

- Managers: Bonus payments on the basis of short periods and high profits, no penalties for failures, no actual liability
- Unrealistic profit targets: 25% ROE
- Securitization of credits or credit risks: temptation to neglect risk control, because risks are no longer obvious
- SIVs and conduits (shadow banks) are formed in order to buy large quantities of securitized products and avoid Basel I requirements

Banks as a problem (2)

- Maturity transformation problem (short-term financial instruments against long-term loans and securities) aggravated, because the collapse of the market for commercial paper with maturities of 30 to 90 days breaks the re-financing chain

Derivatives as a problem (1)

- Products become opaque (CDOs, CDSs, certificates); often the exposure, solvency of the parties and overall risk can no longer be established; experience does not help here
- Risk diversification by means of securitization does not work unless many players carry small portions of risk each. However, gigantic risk packages have accumulated with large financial institutions in the meantime; each of them constitutes a considerable systemic risk

Derivatives as a problem (2)

- Ratings lead investors to believe derivatives are a sound investment, investors trust - even wrong - ratings blindly
- Products are highly complex and cannot be disentangled in times of crisis
- CDSs (insurance on credits) are dangerous instruments: Over-the-counter (OTC = bilateral, hidden from the markets, no market price mechanism), tradable, volume bigger than the underlying, financial standing of the seller or the last owner uncertain

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Hedge funds as a problem

- Institutions that can mobilize large amounts of capital for certain deals, also short-term
- Buy high-risk securities and issue CDSs
- High leverage
- High systemic risk
- Completely unregulated
- Opaqueness is key to their business model -> work with extreme information asymmetries and massive market abuses

Failure of supervisory authorities

- Fragmentation of the authorities, bickering over responsibilities, confusion about who is responsible for what
- Not up-to-date regarding financial market innovations
- No international cooperation, discrepancy of interests between different countries

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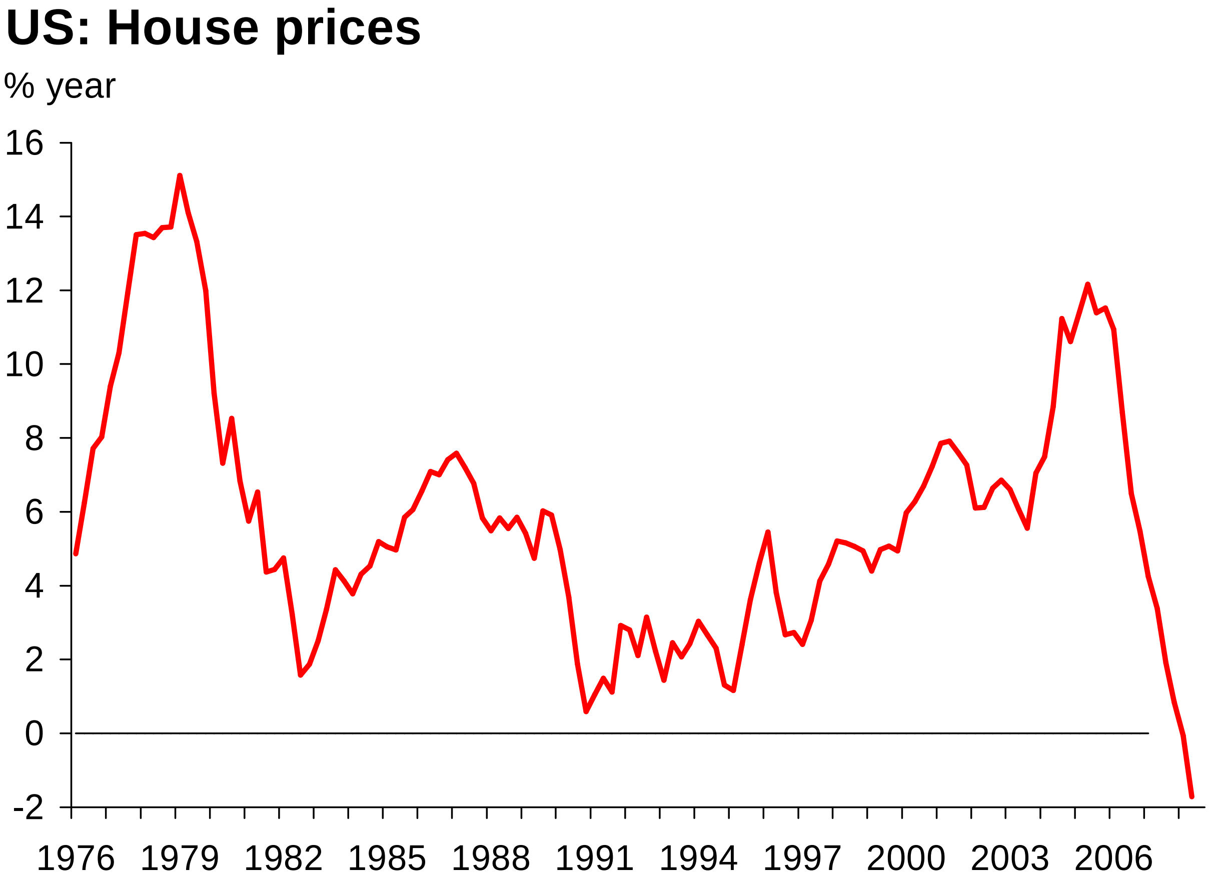
Failure of rating agencies

- Not neutral, have vested economic interests. Conflict of interests between consulting and rating business = First reason for wrong ratings
- Esoteric and opaque risk models, which do not include extraordinary risks = second reason for wrong ratings

The Housing price crash …



Source: Office of Federal Housing Enterprise

Housing price crash since 2006

… as the trigger of the crisis

- The turning point had come when housing prices began to fall after they had increased for such a long time. Particularly subprime loans defaulted (Achilles' heel) with corresponding implications for their ABS-securitization
- Fall in housing prices leads to reduced private consumption
- Sharp rise in mortgage delinquencies and foreclosures

Consumption on lending becomes harder

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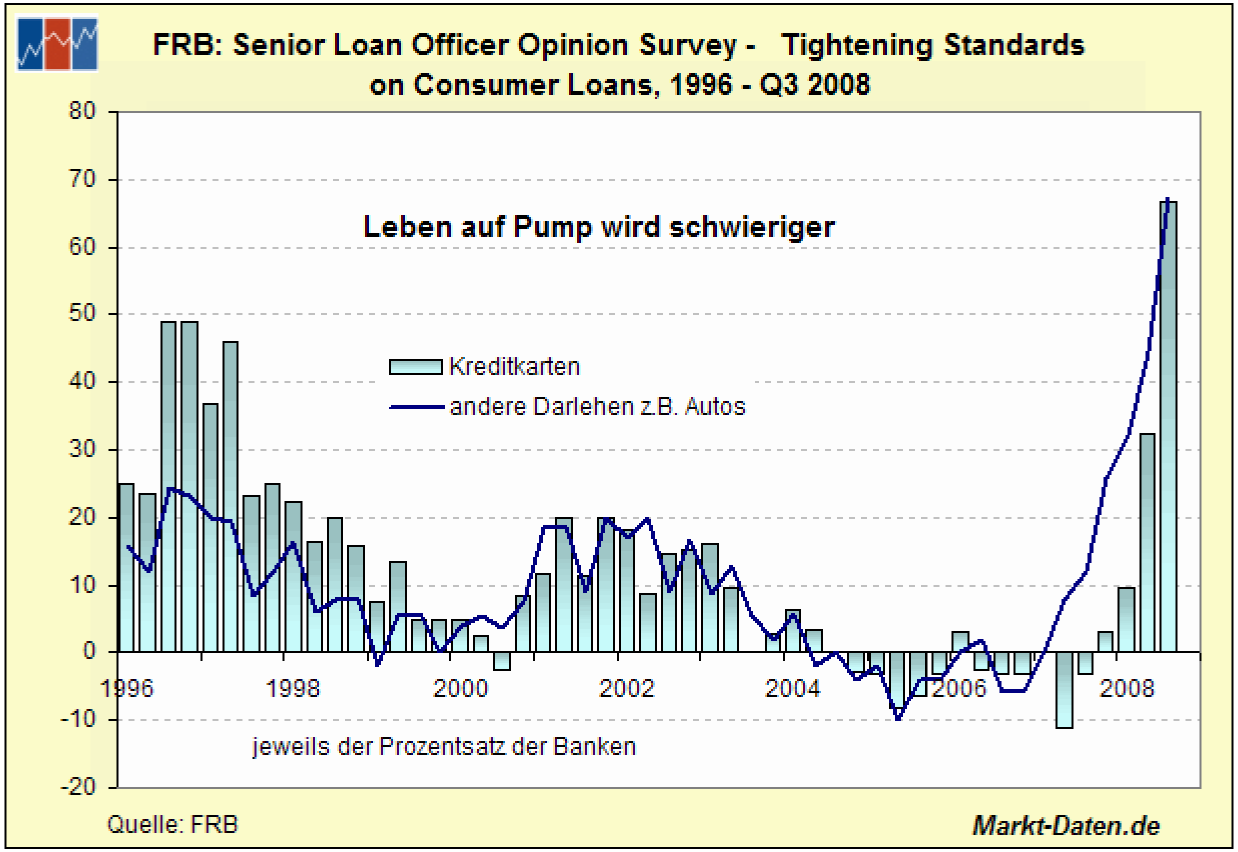
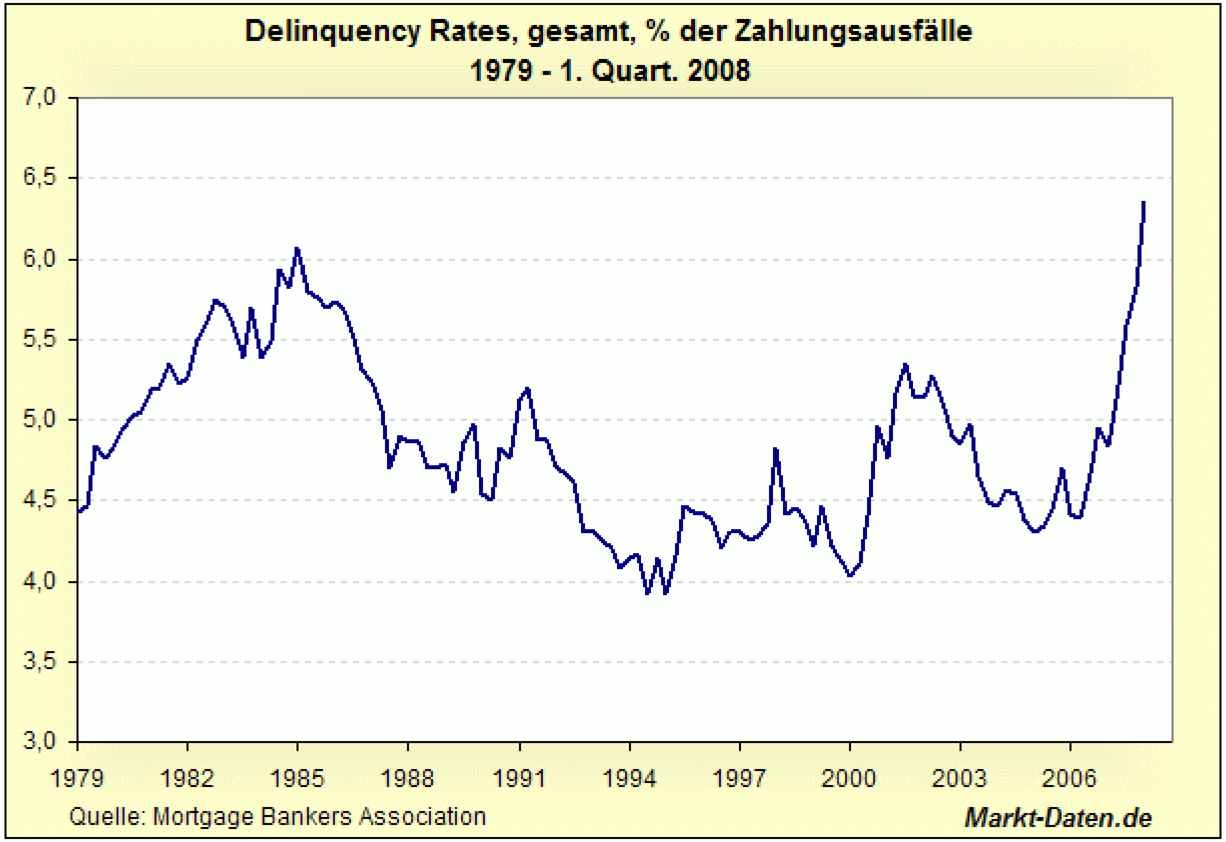


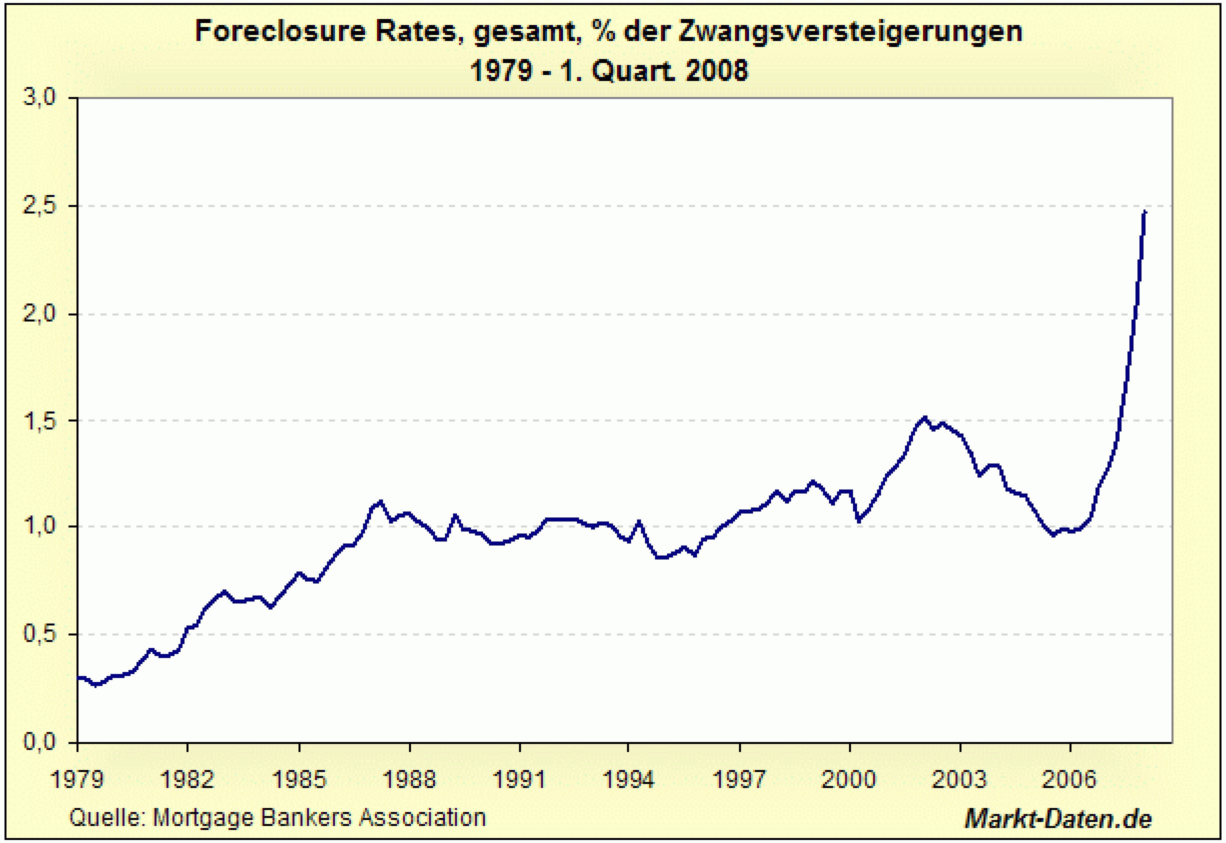
Credit standards are tightened everywhere. Banks clamp down on consumption on credit.

Delinquencies rise



Lots of home owners unable to pay off their debts.

Foreclosures rise



If borrowers default for a longer period there will be forclosures. They have reached a record high.

Chain reactions start (1)

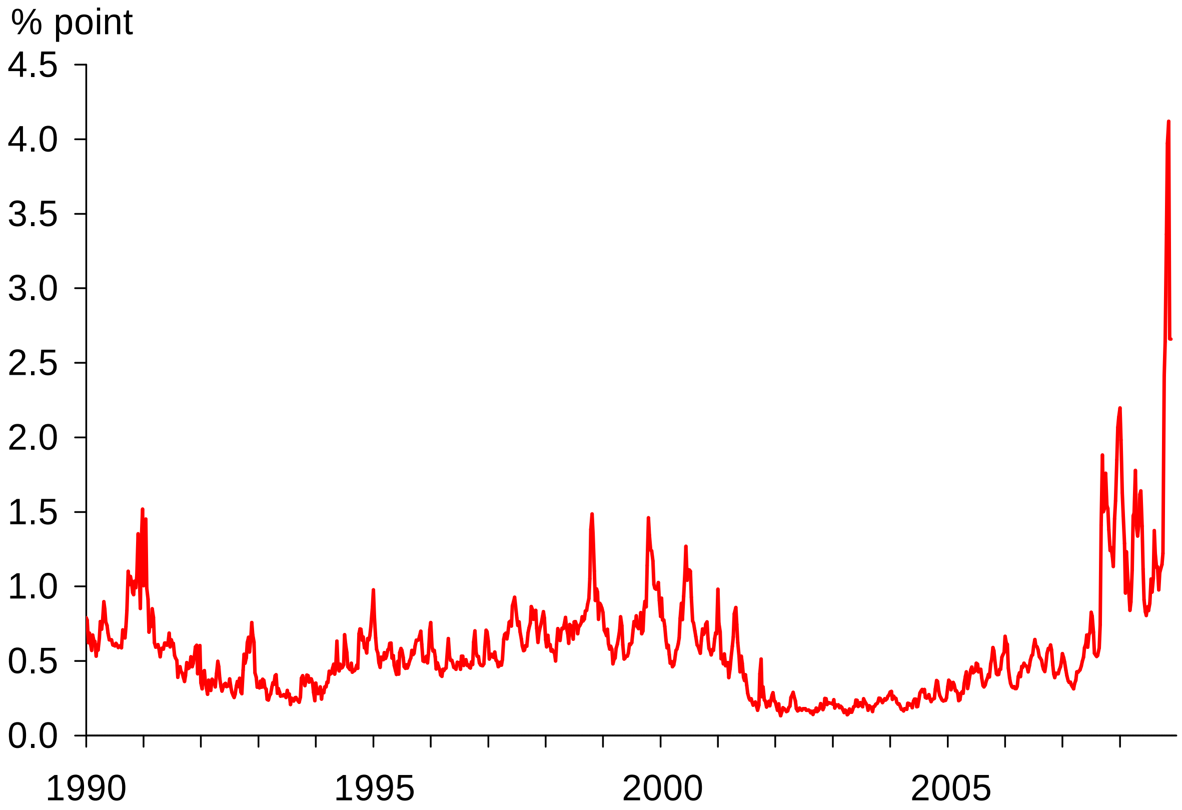
- When debts go bad, the banks’ equity capital decreases, they are forced to sell assets, therefore prices of securities plummet
- Equity capital of affected banks shrinks due to falling value of mortgage securities likewise. They sell assets, and this leads to a generalized drop in asset prices with corresponding implications for all institutions on the market
- With less equity available, banks are forced to reduce lending.

Chain reactions start (2)

- SIVs and conduits: long-term papers are no longer accepted as collateral for short-term commercial paper (cp). Re-financing by cp dries up. SIVs are actually insolvent. Affected banks must step in with credit lines. Billions of losses at Citigroup, Bank of America, Merill Lynch or British and German banks.
- The gigantic excess liquidity built up over 20 years, is withdrawn from the economy in a painful process
- Risk premiums or spreads in many segments soar, even in AAA products.

Mistrust among banks (1)

US: 3 month libor spread over 3 month T-bill



Source: Haver Analytics

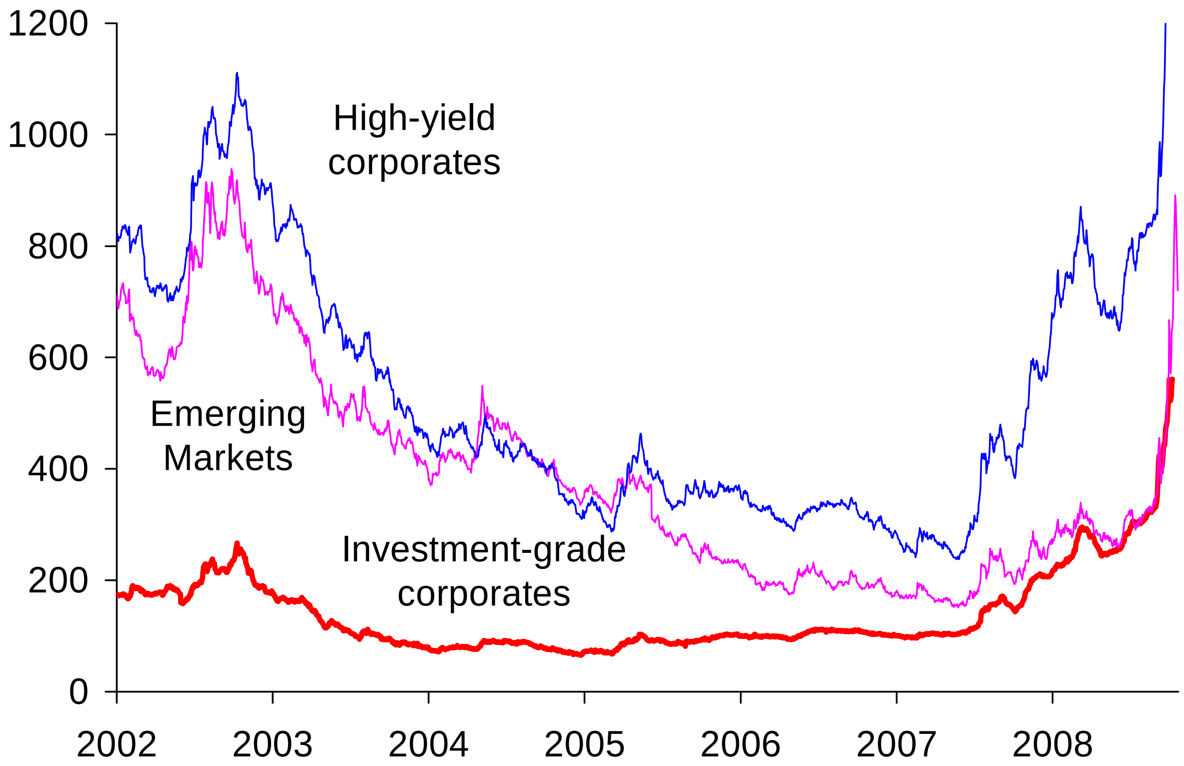
Soaring interest rates in interbank transactions

Mistrust among banks (2)

- The low interest rates of central banks are not used by banks to step up their lending activities, because they …
  - suspect all borrowers to represent too much of a risk, at least a risk that is substantially higher than the interest advantage
  - have to cut back on lending volumes anyway
  - have to collateralize what used to be uncollateralized loans
  - are forced to build up more equity

Spreads of all classes surge

Global bond markets: Risk spreads



Source: Haver Analytics / JP Morgan / Merrill Lynch

All types of securities are affected

Sharp drop of credit markets to be expected

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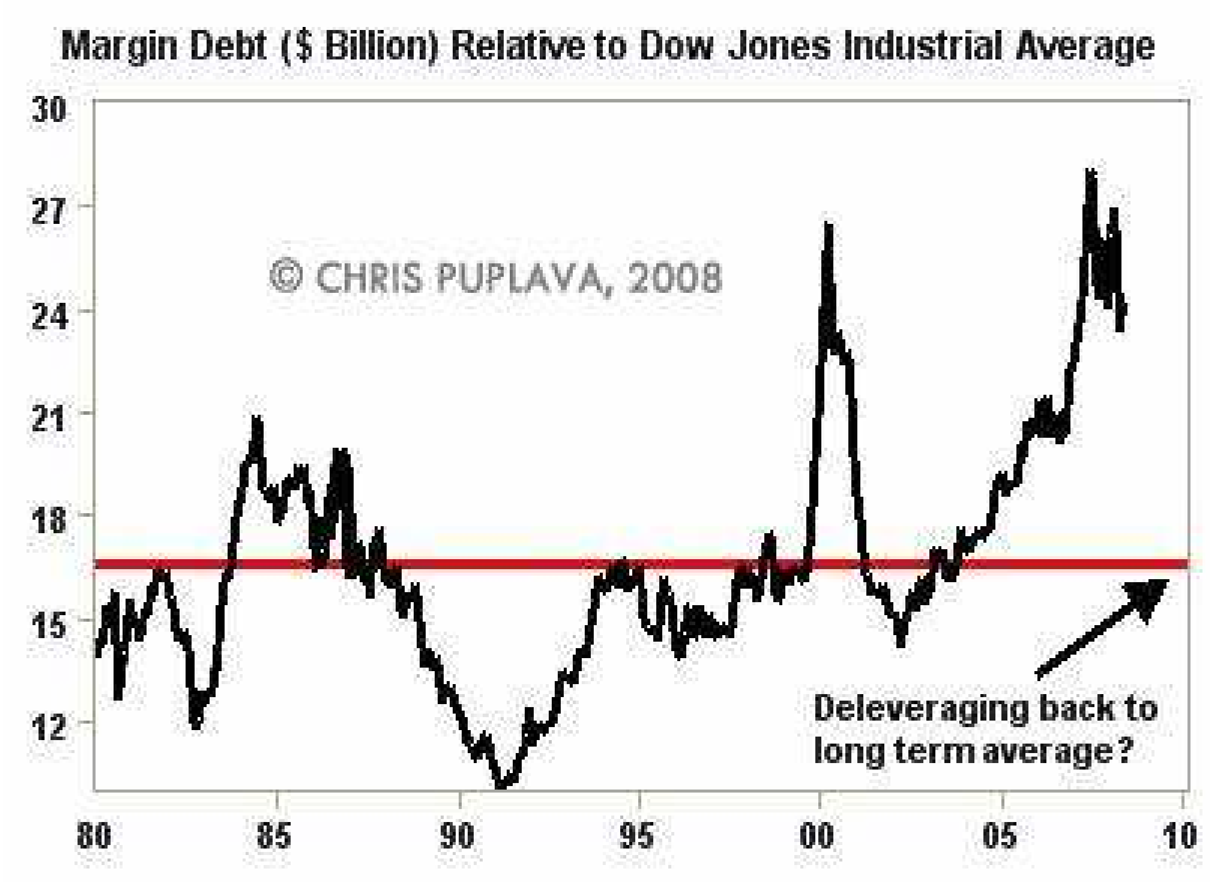

The aggregate credit volumes' drop back to even only "normal levels" would amount to a deep plunge

Further chain reactions

- The USA: More loans go bad in private and commercial real estate, credit cards, cars and students -> aggravation of the bank crisis
- Investors withdraw capital from hedge funds and investment funds -> funds sell assets -> asset prices drop further
- In times of recession, highly leveraged companies owned by private equity funds are faced with insolvency
- If large numbers of underlyings of CDSs default, we can expect markets to collapse when huge numbers of institutional investors rid themselves of their investments at once

The severity of the crisis

- Central banks are powerless in the face of the chain reactions. While they succeed in preventing the financial market’s complete collapse, they cannot stop its massive contraction and corresponding implications
- The crisis is so severe because the Subprime crisis immediately affects the entire banking system
- The immense capital volumes traded on the markets, as well as the emergence of immense systemic risks due to the worldwide integration of financial markets endanger the world economy to an extent much greater than in 1929

Future demands on central banks

- Monetary stability as main aim does not suffice: Extension of the concept of inflation to include asset prices changes in order to be able to counteract speculation and asset price bubbles
- Minimum reserves on all assets of banks with central bank. When bubbles start to emerge, minimum reserve rates can be raised, or slackened in the event of downturns

Future demands on banks (1)

- Lending by banks only
- Sound practice with mortgages
- All risks of the banks to appear on balance sheet
- Clear accounting for special purpose vehicles in banks' balance sheets
- Equity requirements for all risks, in the form of minimum capital ratios
- Higher capital requirements for high-risk transactions, e.g. at least 5-fold for HF
- Higher equity ratios for new products, e.g., 40%

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Future demands on banks (2)

- Bank bonus systems should be based on longer terms, reward sustained success, penalize failures, drastic reduction of golden handshakes
- Real liability of managers
- All securitization items of the banks and her risks have to be disclosed, banks must maintain significant shares of the equity tranche, e.g., 20%
- Limitation of credit leverage
- Procyclic effects have to be removed, e.g., the mark-to-market rule

Future demands on other institutions

- Rating agencies: no consulting, rating models must include high risks, supervision controls, European rating agency
- Securitization and credit derivatives: Certification for financial innovations, radical simplification of financial products, International Clearing House for CDSs
- Hedge funds and private equity funds: Transparency of the business models and the investors, normal tax on income, ban of short selling, limited indebtedness of target companies
- Creation of a central European regulation and supervision instance, e.g., with the ECB