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Financial Markets and Institutions

Impact of Credit crisis on financial market liquidity

The financial crisis which the United States economy had to face during the years of 2007 – 08 was the worst of its kind. The banking system had not faced a crisis of this magnitude since the 1930s which forced professionals who belong to this field to question the state of liquidity of the system. The central role that banking institutions, and which the financial business performs as such, is to provide the public with cash, allow them to make deposits and invest their funds in securities or provide them with term loans when they are in need of liquidity.

The financial crisis of 2007-08 had a very far reaching impact, in so far as it affected the global financial market. Stock markets of various economies had to bear the brunt of withdrawals from foreign investors as they struggled to liquidate their holdings from all corners. The result was that many stock markets crashed because of heavy selling and high level of volatility in the market. A credit crisis of this magnitude occurs when banks issue a large number of loans which are not backed by security or are not covered with any mortgage. When the borrowers default on the repayment of the loan the bank does not have any assets to cover the amount of the loan which leads to a credit crisis. The credit crisis which occurred in 2007-08 was a result of similar loans issued by banks across the United States. These were termed as sub-prime loans and did not have substantial asset cover to back the amount of the loans. The impact on debt market of the credit crisis can be studied under different heads – the impact on bond and treasury market, the impact on securities and share market and the impact on other securities as well as investor confidence.

The bond market showed the first signs of the impact of this credit crisis since investors made a move shift their money from risky investments to safer government issued securities. During the years, 2007 and 2008 the bond market recorded the highest number of investments which further increased as the credit crisis intensified. Not only did this transition result in losses for banks and investors but it also caused the borrowing cost for companies to raise funds to increase. During the crisis, the yield on government issued bonds fell from 5% to 1% while yield on short term treasury bills actually became negative.

The second result of the credit crisis was seen on the performance of the stock market in the United States and other countries, as well. The investors pulled out their investments from financial markets to maintain their liquidity and to cut their losses while they still had the chance to make a small profit or recover what they had invested in the first place. The result of this, coupled with the volatility of the market and the heavy selling done by the investors, was that the S&P fell by 8. 8% in a single day, which the lowest that the index has performed. The United States stock market alone registered a market loss of $1 trillion in one day of transactions. The results were also seen and felt in Asian stock markets where the markets crashed in countries like Hong Kong and India. Russia and Mexico also felt the effects of the credit crisis.

The effects of the credit crisis were also felt in the debt market, especially since this was the point from which the crisis originated. Debt instruments are usually divided into loans and securities. During times of crisis if one institution or a single firm loses its risk capital it will not create any effect in the business. But when more than one company loses its capital it will bring about a negative impact on the debt market, considering that the company had secured loans to finance its capital. Liquidity and the maturity of debt instruments are very closely related. As the investors need to maintain their liquidity, they will be less willing to secure long term loans as compared to short termed ones.

Since, during the credit crisis, the investor confidence was very low, the markets saw very less movement of funds. Most of the funds were concentrated in the debt market as the purchase of commercial papers, treasury bills and the need for bonds increased. A spike in LIBOR also showed that the banks and financial institutions were unwilling to extend loans and finance credits to seekers during this time. Usually for an economy LIBOR is stable, but a spike during the credit crisis showed that the market was highly volatile and liable to suffer losses. This phenomenon was followed by the bankruptcy of Lehman Brothers and many other financial institutions.

Bailout of AIG

The American International Group is one of the biggest companies in the world in the world of finance and insurance. Following the events that unfolded in the year 2008, AIG was faced with the worst phase of the financial crisis that the company had seen. The company had sold credit protection through its London office through credit default swaps on collateralized debt obligations. But the problem started when these securities declined in value. Almost $57. 8 billion worth of debt securities of the company had been backed by subprime loans. The result was that the credit rating of AIG fell leading to a liquidity crisis in September of 2008. Consequences of this were that the company was bankrupted and needed government assistance for a bailout.

At this moment, the United States Federal Bank made a move create a secured credit facility to prevent the company from collapsing. This enabled the company to deliver additional collateral to its credit default swap trading partners. Eventually, the company paid back the government in full, which included a repayment of interest and expenses which were involved in the bailout. The taxpayers of America kept the company afloat till 2012.

It had become necessary for the government to interfere the bail the company out because it is one of the largest financial companies in the country. It had incurred an enormous operating loss which had accrued as a result of reckless insuring of sub-prime backed securities. However, when 400 other smaller financial institutions had been allowed to fold and file for bankruptcy, under the provisions of the legal framework, it was surprising to see that the government should interfere with one company. There was a lot of speculations related to the rule bending which the state justified by stating that AIG’s tax benefit would help taxpayers by raising the share price of the insurers.

Two other adjustments were made by the government to bail out AIG which were when it claimed that the bailout would result in profit to the government when the money would pay back by the company. But when one takes into account the level of risk that the government exposed itself to and also risked the money of the tax payers it can be seen that the deal was made only to favor AIG and was not in the best interest of the public. Also, the opportunity cost involved in this bailout was too high to justify the move by the government. If the government had decided to extend the 30 year loan to the business i. e. to AIG at a fraction of the interest rate and had then been repaid in full, one could have claimed that the government had made a profit on the bailout. But this was not the case and so no justification can be found for the government bailing out AIG.

One should also consider the social cost involved in this move of the government to bail out AIG. These are not captured by profit and loss accounts or through balance sheets, but they do have an impact on the market and especially on the investors involved. One consequence of this move was a depressed rate for savers i. e. those people who chose to save their money in the form of deposits instead of investing it in the business. One cannot also ignore the fact that during the time of the AIG bailout the share prices were artificially inflated by providing special tax treatment only to AIG.

When the last of the payment by AIG had been made, the government reported that it had been a profit of nearly $5 billion. But the cost that the taxpayers had to pay for this and the losses that the business had to sustain during this time defies these profits. It is also known that these profit figures are a result of creative accounting and that the money of the tax payers has been utilized for risky investments by the state.

Had AIG been allowed to fail, other smaller financial firms would still have suffered the fate that they experienced and would have had to file for bankruptcy. Thus the bailout of AIG had no impact on other firms in the financial markets. The only persons who benefited from the AIG bailout were the executives of the company, and the company itself. And if one is to believe the figures provided by the state then they benefited too by using this as an investment. In my opinion, AIG could have been supported by giving out a loan package instead of the bailout package they had been offered. This would have ensured higher returns on the money invested by the government and would also have kept the tax payers money safe, which the government accepted had been speculated in the bailout attempt.

Reference:

CPSS, Report of the Committee on Interbank Netting Schemes of the central banks of the

Group of Ten countries, November 1990.