Capital and technology

Technology

Introduction: Mr. Smith (a fictional character) with a terrible credit rating was righty rejected a mortgage by his bank in the early 1980s. Fast-forward 20 years - Mr. Smith and several others like him were proud homeowners thanks to the new market based banking system. Based on just that, one would assume that the economy in general is doing rather well. In practice however this was not the case and our essay highlights how the new 'spivvy' banking system and its allied activities led to what today is known as the international financial crisis.

Traditional banking: Banks took deposits from customers and lent them to those seeking loans. The interest rate paid on deposits was lower than the interest charged on loans, known as spread or core profit of banks. If customers defaulted, banks held the risk on their books. Banks therefore did thorough due diligence before they sanctioned loans, which in turn kept them relatively safe. (Farrell, 2008) Transition from traditional to modern banking: The U. S.

financial-services industry was deregulated in 1999 with the repeal of the Glass-Steagall Act, which was earlier enforced to control speculation in the stock market and prevented retail banks, insurance companies and investment banks from owning each other. With the Act repealed, conservative banking gave way to reckless banking practices, subprime-lending being one of them. (Farrell, 2008) Market-based / Shadow banking: Greed for profits has led banks to lend more than their deposits.

Where does that extra money come from? They use securitization, a process that converts mortgages or debts into bonds, which are then sold to financial institutions. In its original form securitization was meant to transfer credit risk to those better able to absorb losses, but instead it increased the fragility of the entire financial system by allowing banks and other intermediaries to " leverage up" by buying one another's securities. Banks make profits through fee (for originating the loan) rather than spread.

The bonds were insured, rated safe by rating agencies and were not on banks' books, luring banks to originate even more loans without proper screening (Farrell, 2008). The whole financial system became so intertwined that a failure in one institution meant ramifications across the financial spectrum. Traditional Banking Vs Shadow Banking - In early 2008, the Federal Reserve estimated that the shadow banking system was $20, 000bn in size when compared to the traditional banking system at $11, 000bn.

Now, although lower at $16000bn, the shadow banking system still remains $3000bn larger than the traditional banking system. (Tett, 2010) So what led to the financial crisis? The run on the shadow banking system is arguably the prime reason for today's financial crisis. With the Fed cutting interest rates to 1%, institutional investors chased higher returns. Smelling a growth opportunity, banks structured higher yielding products linked to an ever-rising housing market. Low interest rates lured banks to over-leverage and buy mortgages, which were then bundled into Collateralized Debt Obligations (CDOs).

CDOs had 3 tranches, linked to a level of risk, these were then sold to institutional investors offering returns more than the Fed's 1%. 'The safest tranche offers investors a (relatively) low interest rate, but it is the first to be paid out of the cash flows of the portfolio. In contrast, the most junior tranche will be paid only after all other tranches have been paid. The mezzanine tranches are between these extremes' (Brunnermeier, 2009: 79). This seemed to work well as everyone in the chain made their share of money with every mortgage repayment.