

Lack of regulation in banking industry assignment

[Economics](#)



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What case can be made that it was the lack of regulation of the banking sector that led to the financial crisis of 2008-9? What are the new regulatory structures that are being proposed in the US and UK? The preconditions of the 2008-9 crisis were high unemployment, high growth which was stimulated partially by foreign investment caused by imbalance of current accounts on the international arena (ie. Huge debt of US and the UK and surplus of China, Korea, Japan). Large part of the problem was caused by low inflation – in healthy economy house prices oscillate around the inflation rate.

In this recession prices were raising faster than inflation. Finally, interest rates which were kept low after the dot com bubble (2004) in order to help the economy recover. After the great depression in 30's Glass-Steagal Act (1932) has been imposed. It forbidden commercial banks from taking part in any risky activities. This tight regulation did not allow Banks holding public deposits to get involved in investment banking activities, speculation and insurance business with depositors funds. In 1956 Bank Holding Act modified the original Glass-Steagal Act and increased the amount of allowed activities of the commercial bank.

Those created holding companies, which owned two or more commercial banks and could, carry out activities “ closely related to banking”. Fed was responsible for the list of those activities but they have never been allowed to get involved in Investment banking and Insurance. Financial Services Modernization Act (1999) – allowed companies like Citigroup and Bank of America to become holders of subsidiaries involved in both investment and commercial banking. Under this act Goldman Sachs and Morgan Stanley began to operate Investment Banking.

The risk in this act was that holding companies ran commercial banks that took a vital part of the economy as well as very risky hedge funds. The failure of those last ones would require a bailout from the government or otherwise the entire economy could face a systemic failure. This deregulation started the creation of new bubble. Deregulated banks lending money to sub-prime – under the Community Reinvestment Act which encouraged financial institutions to grant loans to sub-prime market banks began to give loans to people with poorer credit rating.

The mortgages initially were not just given up to the value of the property but in many cases the amount of loan was far greater than the value of the real estate behind that loan. These loans were and additional cash that could have been spent in any way not necessarily the way that would increased the value of the house (refurbishment or extention). People were spending that money on mostly imported goods fuelling the foreign investment even more. House prices were going up stimulated by demand created by sub-prime buyers – self fulfilling prophecy and creation of the bubble.

Banks by granting loans to another part of the market that previously could not afford the ownership, increased the demand for properties and its prices. Higher prices required even more lending. That created the euphoria on the market when investors believed they will have constant profits incorrectly anticipating that prices will grow indefinitely. That lead to financial abuses – granting loans despite low credit ability. Banks were lending money to anyone with assumption that even if borrowers default on their payments the value of house was going to rise and the property could be sold by the bank with profit.

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Lack of regulation and not effective implementation of existing regulations allowed the involvement of banks in this sort of activity. Credit rating agencies play an important role in rating debt created by the banks. They failed to correctly assess the securities with too optimistic approach. Holders of those securities did not actually know how risky their portfolio was. Securities and Exchange Commission (SEC) being responsible for making sure that securities (backed with sub-prime mortgage) were reliable and credible failed to do so.

The level of defaults in the sub-prime market was over 10% whilst the prime market was around 2%. The price decrease in real estate led to banks not being able even to recover the amount they invested. When the speculative subprime market went into crisis it only began much bigger recession. Behind the sub-prime there was another crisis – the financial innovation products: CDO's, CDS's, derivatives, futures market, which were directly interlocked with sub-prime loans. Creation of a secondary « shadow market» with no transparency and lack of government regulation.

Banks were continuously and artificially creating enormous amount of money. Derivatives which are essentially just bets (on virtually anything: price of commodity, exchange rate, inflation, currency exchange, etc.) have become a huge market worth over \$700 trillion. The problem with them is that there is no physical value behind them and if things go wrong one has to face loss of all the money that has been invested. Shadow banking system has developed further based on the innovation and creation of new over-the-counter financial solutions.

The illegal practices were allowed to flourish. It is known now for example that Credit Default Swaps even though they are a type of insurance, were sold as derivatives. Credit Default Swap is the financial solution of spreading the risk of defaulting on repayment of the loan. It is an agreement that one side gets paid for accepting to pay off the other side's debt in case they are unable to pay it back. Should they were sold as insurance, according to law, they would have had to be backed with a capital reserve and subject to rigorous regulation.

Selling CDS's as derivatives actually deregulated this market and lifted the requirement of capital reserve needed in case something goes wrong. Since their value in 2008 reached \$60 trillion it was a serious matter. That amount was more than the world GDP. Such figure would be very difficult to achieve if they were properly sold in accordance with the rules – as insurance. None of the financial companies did not in fact have sufficient reserves. However, because the CDS-s were recorded as derivatives, the market had been facing an ongoing growth since 2001. Another significant part of the shadow banking was common practice of high level of leverage, that is using loan to increase investment from which expected yield is higher than the cost of borrowing. This activity is considered risky because in case the investment doesn't bring expected revenue the investor has to bore the costs of the loan and is responsible for severity of this crisis. With no banking regulation and lack of government control over the entire shadow banking sector the finance crisis led to vastly spread economic crisis and ultimately to debt stagnation (private and public debt). Banks stopped lending money to themselves, to companies and to private people.

There was no available credit in economy that affected everyone's cashflow. Government having a risk of systematic failure had to bail out banks and increased the national debt even more. With higher budget deficit wages were frozen or even cut. Other important national expenses had to be reduced. Imbalance of payments, and new technology (Internet connection, new software) caused new extraordinary risk that has been created in 1990's and 2000's – huge amount of money could travel across the world within seconds. Giving a powerful tool for investors to react quickly and make profits.

The problem is that money can be withdrawn as quickly as it was flowing in. There have been opinions that we are dealing with the end of capitalism. The present situation may, however, mean the beginning of a more socialised economy. For that to happen, governments should powerfully intervene: impose of regulation on the shadow banking system, break down the holding companies and separate commercial banking from any high risk activity, and finally reduce unemployment. However, it will be very difficult if they continue spending taxpayers' money for next financial system emergency programs.

2. 3. Bank activities regulation Many risky financial service activities are often legally separated from traditional bank operations. Three broad types of non-banking activities are securities services (underwriting, issuing and distributing securities), insurance and real estate.

3 The argument for these financial activities being separated from commercial banking activities (deposit taking and commercial lending) is because they, particularly securities services, could increase the risk level of the financial conglomerate as a whole.

Asymmetric information in financial markets will also make monitoring difficult if banks engage in various financial activities. In addition, allowing a wide array of financial activities may extend the safety net for lending to non-bank activities and encourage banks to take excessive risks with their securities portfolios, thereby jeopardizing the stability of the financial system. • • A financial innovation provided a major impetus to expand mortgage lending; Increased lending raised housing demand, which in turn raised house prices; ?

Rising house prices encouraged still more lending, thus creating a self-fulfilling and continuing circle of rising lending and rising house prices. Eventually, an affordability crisis and market crash occurred, as the market prices for housing became inconsistent with the economic fundamentals of homeowner affordability. • • Steps of creation of speculation bubble: 1. Price decrease 2. Government intervention and introduction of new regulations o Banks taking part in speculations and risky derivative market: Financial innovation – crisis – regulatory response • • • the repeal of Glass-Steagall allowed them to merge with other financial services, such as insurance. This is why the banks are so tightly interlocked so that disturbances in one area set up huge shocks through the whole system. • With the problem posed in this manner, the general structure for the solution becomes clear: one must separate the two activities in a manner that makes the infrastructure division fully bankruptcy remote from any losses created by the hedge fund division. • • The Glass Steagle Act – Separation of investment banking risky activities and commercial banking • banks were tightly regulated, and could not by law make too risky investments directly with depositors money. Then, they

were allowed to offer higher return (risk) products to compete with money market funds and investment banks, and then • Methods: • The Monoline Insurer Solution – financial institutions dealing with finance should engage only in one certain type of insurance. Standard line – like car insurance, where risk of massive claim is far smaller than, Risky line – like sub prime insurance when massive claim is possible and can cause the insurer to default on their debt.

Separation of these two activities secures Standard line insurance policyholders. • [pic] • Przypisy: [1] Lewarowanie – mechanizm używany podczas inwestowania, polegający na wykorzystywaniu dźwigni finansowej, czyli wspomaganiu się przy inwestycji kredytem, pod warunkiem jednak, iż nastąpi zwiększenie zysków przynajmniej w stopniu pozwalającym na spłatę kosztów pozyskania kapitału (przyp. red.). [2] Swap na zwłokę w spłacie kredytu – instrument pochodny, służący przenoszeniu ryzyka kredytowego.

Jest to umowa, w ramach której jedna ze stron transakcji zgadza się na spłatę długu należnego drugiej stronie transakcji od innego podmiotu, w przypadku niespłacenia kredytu przez tego ostatniego (przyp. red.). [3] Więcej na ten temat znaleźć można w: „ A Bad Idea: A financial Solution to the Financial Crisis”, [www. HuffingtonPost. com](http://www.HuffingtonPost.com). excitement by a high short term rise and excuses risky investment that in long run is unsustainable – risk of lending money to sub-prime lenders was not correctly assessed Iso unregulated trading of securities (shadow banking) affected large corporations not directly linked with mortgage sector. The financial structure was so large and complicated that even people within the industry couldn't tell where their money is being invested. That's important, and it's a big part <https://assignbuster.com/lack-of-regulation-in-banking-industry-assignment/>

of the mess, but it's not the real key. What really created the disaster is a combination of leverage – that is, borrowing money to amplify an investment, and derivatives – fancy investments that are really nothing more than bets. [pic] [pic] [pic] [pic] [pic] Investment bank losses are due to failed bets on leveraged derivatives [pic] [pic] [pic] [pic] “ Asked what had been his biggest mistakes in office, the PM said: “ In the 1990s, the banks. They all came to us and said ‘ Look, we don't want to be regulated, we want to be free of regulation” – source [pic] Regulatory reform of F&F has been a continuing quest for most of the firms' history, and with a notable, even remarkable, lack of success. The primary case for regulatory reform has always been based on the systemic risks that the firms pose for the US mortgage and financial markets.

But in the absence of an actual crisis, the firms were always able to deter any serious action; for example, the firms would argue that regulatory reform was tantamount to eliminating their mission to expand homeownership. The lobbying power of F&F in this regard is legendary. [pic] [pic] [pic] Międzynarodowy Fundusz Walutowy opublikował ostatnio interesujące dane, ukazujące w jakim stopniu lewarowanie finansowe ponosi odpowiedzialność za większą dotkliwość obecnego kryzysu w porównaniu do trzech wcześniejszych, poważnych kryzysów, począwszy od lat 80.

Z publikacji wynika, iż lewarowanie finansowe wniosło dodatkowe 20% do narastającego już wcześniej kryzysu bankowego, doprowadzając obecne załamanie do poziomu równego 40% globalnego PKB, podczas gdy wcześniejsze kryzysy rzadko kiedy przekraczały 20%. [pic] [pic] Lack of regulation of banking industry: 1. Regulacja o zakazie zwiększania

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papierowego i depozytowego pieniądza w obiegu. 2. Regulacja o wykorzystaniu rezerw banków centralnych do przywrócenia standardu kruszcowego i pełnego pokrycia pieniądza w obiegu. 3. Regulacja o zakazie manipulacji rynkowymi stopami procentowymi. . Regulacja o zakazie emisji długu publicznego. 5. Regulacja o rozwiązaniu banków centralnych. 6. Regulacja o zakazie jakiegolwiek dotowania i wykupywania prywatnych podmiotów przez państwo. 7. Regulacja o likwidacji spółek specjalnego przeznaczenia jak Fannie i Freddy. 8. Regulacja o likwidacji Community Reinvestment Act, który zmuszał do udzielania kredytów subprime. 9. Regulacja o rozwiązaniu kartelu agencji ratingowych. 10. Regulacja o zniesieniu regulacji bazylejskich, które okazały się kompletną kląpą. [pic] The reason is that the crisis is due to loans not being repaid.

The only way to have prevented that would be to have prevented the loans from being made. The only way to do that would have been to deny credit to low-income people and people with bad credit. [pic] As big a problem, according to the IMF, was that financial regulation was flawed, ineffective and too limited in scope. What it calls the “shadow banking system”—the loosely regulated but highly interconnected network of investment banks, hedge funds, mortgage originators, and the like—was not subject to the sorts of prudential regulation (capital-adequacy norms, for example) that applied to banks. pic] Banking crises, banking regulation and the real economy Banks and financial institutions enhance economic performance through their role in financial intermediation. By pooling funds from depositors and lending to producers, financial intermediaries should contribute to an efficient allocation of capital and a reduction in transaction costs. Evidence of

bank development contributing to economic development is found in many empirical studies, especially the influential work by King and Levine (1993).

The interruption of financial intermediaries' function, on the other hand, can lead to a downturn in an economy, since a decline in the supply of credit reduces households' and firms' abilities to spend and invest (e. g. , Agenor et al. , 2004). Since bank failures may have an adverse impact on the real economy, banks are strictly regulated. 2. 1. Deposit insurance Deposit insurance is a financial safety net instrument established to prevent bank runs and protect the payments system. As Diamond and Dybvig (1983) theoretically argue, bank runs can be self-fulfilling phenomena.

A run on a bank can spread contagiously through the financial system as a whole if depositors, who have incomplete information on whether financial problems are bank-specific, panic and withdraw their funds simply because other depositors are withdrawing. Deposit insurance plays an important role in reducing the likelihood that one bank's distress can cause a full-fledged banking crisis. Deposit insurance, however, is a source of moral hazard that increases banks' incentives to lend excessively due to their limited liabilities or the assurance that depositors' funds are guaranteed.

When loan losses start to mount, bank capital is eroded. When banks have fewer resources to lend or when they are unable to channel funds efficiently, economic activities may contract sharply. In other words, deposit insurance increases the likelihood that an economic contraction is worsened by a credit crunch. Only a few empirical studies examine the relationship between deposit insurance and the degree to which economic contraction is induced

or worsened by the disruption of banking systems (e. g. , Hutchison and McDill, 1999; Hoggarth et al. 2005). These studies find that deposit insurance reduces the magnitude of output contraction associated with banking crises.


2 One limitation of these two studies is that they use a 0/1 dummy to proxy the system of deposit insurance. Most empirical studies in the literature explore a related, but different, question regarding the role of deposit insurance. Studies such as Demirgu ? c ? -Kunt and Detragiache (2002), Barth et al. (2004) and Angkinand and Wihlborg (2006) explore the effect of deposit insurance on the stability of 2 Hoggarth et al. 2005) find that unlimited coverage systems reduce the magnitude of output growth contraction, whereas limited coverage systems do not have a statistically significant impact. A. P. Angkinand / Int. Fin. Markets, Inst. and Money 19 (2009) 240–257 243 financial systems, not on the costs of financial instability or economic activities. In these studies, financial stability is proxied by the occurrence of banking crises. 2. 2. Capital adequacy regulation and supervision Bank capital serves as a buffer against unanticipated losses that could result in insolvency.



Regulation requiring banks to hold sufficient capital and bank supervisors to monitor banks' capital adequacy are important ways to control banks' risk taking, particularly in the presence of deposit insurance. Capital adequacy requirements and strong bank supervision, therefore, should limit banks' risky lending and the adverse impact of bank failures on the real economy. Existing empirical studies employ both the country- and bank-level data to study the effect of bank capital regulation and supervision on banks' risk taking. Empirical results are mixed. Many studies, including Barth et al.

(2004) and Angkinand et al. 2006) find that bank capital adequacy limits banks' risk taking. Calem and Rob (1999), however, find a U-shaped relationship between bank capital and risk taking. They explain that at higher capital levels, banks increase their risk taking as their capital increases, since these banks have a low probability of insolvency. For the effect of bank supervision, Barth et al. (2004) and Angkinand and Wihlborg (2006) do not find a significant impact on banks' risk-taking and the probability of banking crises. However, particular types of banking regulation and supervision can have an impact, as noted in Beck et al. 2006). They find that regulations and supervisory practices which force banks to disclose accurate information and enhance private monitoring tend to limit the risk taking of banks. Opposing arguments, however, point to the benefits of fewer restrictions, namely increasing portfolio diversification, enhancing competition and improving resource allocation. Empirical studies on the effects of bank activity restrictions on the financial systems and real economy are limited, in part, due to the lack of cross-country comparison data for bank activities regulation. Among a few studies, Barth et al. 2004) and Bystrom (2004) find that more restrictions on bank activities, including restrictions on banks owning non-financial firms, increase the likelihood of banking crises. Barth et al. also find that activities restrictions reduce bank development. Unlike these two studies, which use country-level data in their empirical analyses, Gonzalez (2005) uses bank-level data for a cross-country analysis and finds that more regulatory restrictions reduce banks' risk-taking opportunities. 3 See Claessens (2003) and Barth et al. (2004) for additional reviews for bank activities regulation. 244 A.

P. Angkinand / Int. Fin. Markets, Inst. and Money 19 (2009) 240–257 There are no studies that focus on the relationships between bank capital regulation, bank supervision and bank activities restrictions with the output costs of banking crises. [pic] Banki na rynku nieruchomości Powstawaniu banki sprzyjało wiele czynników – jedne o charakterze makroekonomicznym a inne o zasięgu lokalnym (o których poniżej). Powszechnie najczęściej uznaje się, że główną przyczyną powstania banku była polityka makroekonomiczna amerykańskiej Rezerwy Federalnej, kierowanej do 2006 roku przez Alana Greenspana.

FED pod jego rządami, aby podnieść amerykańską gospodarkę z recesji w 2001 roku (pogłębionej atakami z 11 września) obniżył stopy procentowe do bardzo niskiego pulapu, co przy wysokim wzroście gospodarczym przez długi czas akumulowało wzrost inflacji i w rezultacie zmyliło Greenspana, który dopiero w 2004 roku zdecydował się do prowadzenia polityki antyinflacyjnej, która uruchomiła spadek cen nieruchomości i kryzys hipoteczny. Było już jednak za późno bo spekulacja na rynku nieruchomości trwała w najlepsze. [pic]Wzrost ilości kredytów typu subprime, źródło: Wikipedia. org W związku z wzrostem cen nieruchomości coraz większa ilość Amerykanów zaczęła inwestować w rynek nieruchomości. Było to również możliwe na skutek rozwoju rynku subprime mortgages (kredytów o niskiej jakości, dla ludzi bez historii kredytowej, zabezpieczenia bądź zdolności kredytowej), który sprawił, że popyt na nieruchomości znacząco powiększył się o osoby dotychczasowo nieposiadające zdolności kredytowej, co jeszcze bardziej nakreślało koniunkturę.

Segment kredytów subprime powstał w latach 70 XX wieku i w dużej mierze pozostawał poza nadzorem FED-u, także dlatego, że udzielały ich instytucje niebankowe. Wzrost ilości kredytów typu subprime stał się dużym problemem amerykańskich banków, gdyż ich niesplacalność wynosiła około kilkunastu procent, gdy przy normalnych kredytach (prime) oscylowała około 2 %. To sprawiło, że coraz większa ilość kredytobiorców była narażona na każdy spadek koniunktury na rynku i zmianę ceny nieruchomości, która wiązała się z powstaniem problemów w obsłudze kredytu.  The idea of derivatives as insurance is based on hedging. Suppose you invest \$1 million in oil futures, based on the assumption that oil is going to go up to \$200/barrel; so you buy the futures for oil at \$150/barrel. Then the price of oil plunges to \$90/barrel: suddenly you're losing a ton of money. You want to protect against that. So you buy a derivative that's betting on the price of oil going down. You buy enough of it so that if the price of oil goes down, you'll make enough from the derivative to break even.

Now between the derivative and the oil futures, you're guaranteed to at least break even. That's the idea of derivatives as insurance: you make an investment that might lose money, and then you buy a derivative betting that you'll lose money; then if you lose, the derivative covers you, and if you win, the cost of buying the derivative was the cost of insurance.  One of the reasons the losses are so big is that the entities involved were banks. Banks can create money, which is one of the reasons that they were heavily regulated from the Great Depression until recently.  It's sensible for an owner of an asset to hedge against the risk the asset will lose value. The problem with credit default swaps was that the buyer didn't need to own the

asset. So the swaps became ways for investors to gamble on market trends or on companies. Also, since the swaps are unregulated; details are murky, which adds to confusion. [pic] The crisis itself is largely due to unregulated securities, and the ridiculous 30: 1 leverage allowed to investment banks [pic] I think it was lack of effective regulation of the shadow banking sector in general (i. . the regulations that did exist in the shadow banking sector were not directed at the right issues, thus, it's possible to believe, as I do, that some of the deregulation was warranted while still believing that needed regulation was missing). The shadow banking sector should be under the same regulatory umbrella that traditional banks are subject to, and extended the same sorts or privileges within the Federal Reserve system in return (deposit insurance of some type, and lender of last resort functions in return for regulatory restrictions). pic] Deregulation and desupervision were the origin of this crisis: the 1999 Gramm-Leach-Bliley Act repealing Glass-Steagall, and the Gramm-authored loophole legitimating credit default swaps in 2000 [pic] the lack of regulation over the inception and growth of the shadow banking system is more to blame, the reality seems to be that there were a number of contributing factors to the current crisis. As was pointed out in another thread proper valuation and allocation of risk as well as agency issues in the brokering, lending, and securities markets also contributed to the current crisis. pic] One is to hedge price risk; the other is to gamble on price risk. And there are means within the over-the-counter market to gamble on price changes in an enormous way, putting up very little up-front money so that entities are tremendously leveraged. And that means that they can make tremendous profits when the price moves right

for them. But when it moves wrong, they can collapse like AIG did. [pic] BE

2168 Assignment 2 hand-in Tuesday 4th May 2010 11. 00am

What case can be made that it was the lack of regulation of the banking sector that led to the financial crisis of 2008-9? What are the new regulatory structures that are being proposed in the US and UK? Word limit 1500 words maximum (strict limit) Guidance for the essay. Remember this is supposed to be an economics essay. Many students in their first assignment used journalistic language since they are often using this as their source reading. Try to frame your essay within an economic model or at least major economic concepts.

Think about the essay initially in terms of an S-C-P model, and then use ideas in Industrial Economics like concentration, barriers to entry, deregulated markets, the presence or absence of regulatory authorities, economies of scale and so forth. Centre your essay around economic concepts. Avoid exaggerated language and adjectives (as used in the press and news). Remember there is no time for vague, imprecise introductions (what I call waffle). At some point you are going to have to understand and comment on the dismantling of the Glass-Steagall Act and grasp what was driving the move towards deregulation.

Those students who gain higher marks will do so because, in addition to the above, they will understand something of the extraordinary risk that developed in the emerging financial system of the 1990s and 2000s. I gave an open lecture on the economic crisis and recession on the 24th March. None of your year could attend given your econometrics exam. I will repeat

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this lecture at the start of next term. I am not sure whether I will do this as part of the lecture series of BE 2168 or have another separate lecture.

Keep tuned into SS announcements. It concerns the banking crisis and will be very important for your assignment. At any rate attendance in the first couple of lectures at the start of term is vital. References All these have been ordered for the library – but in small quantities and only recently so you will have to check if they have come through. It might be better to get your own copy of some of them (maybe Amazon). Many of them are very easy to read and are quite cheap in paperback. Primary references

Krugman, Paul The return of Depression Economics (2008)

Cassidy, John How Markets Fail: The Logic of Economic

Calamities(2009) Stiglitz, J The Roaring nineties: why we.... ”

Niall Ferguson. T The Ascent of Money: A Financial History of the

World Roberts, Michael The Great Recession Rasmus, Jack

Epic Recession: Prelude to Global Depression Secondary background

references Box, Steven Recession, Crime and

Punishment Congdon, Tim How to Stop the Recession

1 It is also worth re-reading the seminar handout (in text book by Lipczynski J, Industrial Organisation) on European banking. A major reference source for this essay is the abundant material on SS in the Recession folder in External links. This had hundreds of articles, news clips and even videos, some of which are excellent and up to date. I have shown the location of these to you in lectures.

Of great importance is the series of video clips and extracts from interviews with key players and economists in the U. S. financial crisis. These are in External Links in another folder called Financial crisis and regulation. These include: Born and the CFTC. The gap in banking regulation. The Glass-Steagall Act -the decline of banking regulation and its contribution to the crisis. Stiglitz J. Massive failure of financial markets. Michael Greenberger interview on crisis. Levitt interview on financial crisis.