Major reasons for financial crisis of 2008 research papers example

Finance, Investment

Letter of Transmittal

Designation, Department Name

Dear Professor Name,

I hereby submit a report requested on ‘’Major Reasons for Financial Crisis of 2008’’. In order to provide an authentic and resourceful report, I have referred to some of the best academic and research resources.

Regards,

Introduction:

It has been 6 years now since the news of bankruptcy of Lehman Brothers shook the global financial world. The intensification of the global financial crisis following bankruptcy and dis-solvency of leading investment banks, corporations, commercial banks, etc. had made the economic and financial environment very tough for the world economy. By early 2009, whole of the financial system and the global economy was trapped in a crisis and was appeared to be locked in a descending spiral where many economists warned That ‘’The Great Depression’’ might appear again.

Economic Policy were going impotent; trillion of bailout funds were issued to the corporations, volume of negative financial news was increasing and people around the world were scared of their financial stability. Over the years, there have been many discussions like what caused the financial crisis of 2008 and this report has discussed some of the most significant causes of the financial crisis.

Causes of Financial Crisis:

i)The Burst of Housing Bubble

Courtesy its low interest rates, Federal Reserves allowed for an unsustainable bubble in the housing market. During 2001-2004, federal reserve cut the interest rates by 550 basic points and since the monetary policy was too loose, it allowed for an uncontrolled rise in housing prices in the United States. In an extensive analysis, policy rates in US reached just one percent during June 2003 which were held steady for almost a year till 2004. As a result of loose monetary policy, the consumption and investment expenditure in the country were at record high and as a consequence of low real and nominal interest rates, housing prices started increasing. In other words, credit inflated the housing bubble.

However, later during 2006, when consumption demand was exceeding the supply, Federal Reserve finally started increasing the interest rates. Moreover, there was excessive supply of housing properties as real estate agencies had anticipated the demand for housing properties to grow. In 2005, around 2 Million new homes were constructed which was a record construction in the United States. Hence, with high interest rates and supply outstripping demand, the housing bubble finally bursted. The burst began in the first quarter of 2007 and lasted till the end of 2009. During these two years, the US houses lost $6 trillion in market value. In other words, the burst of the bubble resulted in a loss of $53000 for every US household. Subsequently, the value of the house was much lower than what the individual has borrowed from the bank. As a result, banks were not even able to cover their loan amount and even the borrowers were not induced to pay

their debt back as the value of their home had remained half of their loan amount. Hence, the burst of Housing Bubble not only affected the US households, but also the commercial banks who list billions of dollars from the collective non-repayment by the borrowers.

ii)Sub-Prime Lending

Sub-prime Lending is the practice of lending loans at rate higher than the prime rate to those individuals who do not qualify for loans at prime rates of banks. The premium rate charged on borrowing is because of poor credit history of the borrower and the associated high risk which lending institution assumes to take is translated to higher interest rate than market interest rates. The additional interest rate will charge some substantial dollar amount from the borrower over the whole span of borrowing.

The term was viral during the economic crisis of 2007 when large sub prime lending agencies went bankrupt on account of collective default of millions of sub prime borrowers. While, speculation by real estate companies and low interest rates offered by Federal Reserve was a major contributor in initiating the financial crisis of 2008, the result would not have been so magnified in the absence of ‘ Sub-Prime Lending. In other words, proliferation of risky mortgages contributed significantly in the financial crisis.

During the time of the housing bubble when the investment expenditure in US was on high, credit was not only available for quality buyers but also to sub-prime buyers i. e, borrowers who have poor credit history and are more likely to default. Generally, sub-prime lenders are denied the mortgage loans while allotment of funds is charged at high interest rate so as to discourage them from borrowing loans. However, amidst the housing bubble; both of

these regulations were relaxed, and credit was open to all. As a result, the standard criteria used for lending loans to the sub-prime borrower fell and so do the interest rate charged from them.

Soon the sub-prime mortgages started increasing in the banking sector as banks attracted more and more sub-prime borrowers amidst low interest rates and relaxed regulations on borrowings. By the end of 2003, 1 out of every 12 borrowers was a sub-prime borrower and by the end of 2005, 1 out of every 5 borrowers was a sub-prime borrower. As a consequent, during the trend of the housing bubble, mortgage borrowing doubled from $0. 50 Trillion in 1998-2002 to $1 trillion per year, in 2003-2006. This swell in housing demand, which helped drive the rapid post-2003 price increase, can largely be attributed to the proliferation of sub-prime lending. However, the credibility of sub-prime lending was lost with the burst of the housing bubble.

When prices started falling in the late 2006, sub-prime borrowers proved more likely to default than the average borrower. Paying their home loans back was not possible for the sub-prime lenders with the burst of the housing bubble as equity home loans shrank. Sub-prime borrowers had no other alternative, than to default on their borrowing, and when this collectively happened in the United States, banks lost their capital in billions of dollars and economy was left to welcome the financial crisis.

iii) Securitization and Financial Innovation:

The financial markets and institutions have grown extensively over the years, and this has given rise to financial innovation in the form of new financial products like derivatives, Mortgage Backed Security(MBS), etc.

However, financial innovation has increased the complexity in the financial world. For Instance, securitization of mortgage securities was thought to earn high nominal rate of return without any significant risk and the growth of innovative financial products was lauded by the financial industry as it was expected to reduce the banking system risk. However, all the expectations went false when it was found that securitization is the main contributor to originate and distribute model that reduced the lending institution's incentive to be prudent and led to the financial crisis. In the light of huge investor demand for sub-prime lending, banks issued the loans and securitized them as AAA Bonds. These mortgaged backed securities were widely distributed to investors which later caused repercussions, globally, when sub prime lending went into a financial disaster in 2007. Hence, it was evident that these new financial products were not well understood, and their risk was underestimated by the banks.

In a detailed analysis , during the early years of 2000's, investors around the world were expressing high demand for mortgage backed securities citing high returns associated with them. In order to commensurate the increasing demand, mortgage lending banks intensified their search for more borrowers who ended up with the huge amount of lending to sub-prime lenders i. e borrowers with poor credit history. Most of these loans were allocated on a very low margins and with low teaser payments. Since financial institutions were following " originate and distribute" model, these mortgages were securitized. In combination with strong growth in complex credit derivatives and the use of credit ratings, the mortgages, inherently sub-prime, were bundled into a variety of tranches, including AAA tranches, and sold to a

range of investors.

However, as inflation started picking up in the economy during 2004, the US Federal Reserve declared to tighten the monetary policy and withdraw any monetary accommodation. As the interest rate started to increase, the mortgage payments of all the loans started increasing. On the other hand, tight monetary policies resulted in the burst of housing price bubble. Hence, depressing housing prices and increasing mortgage payments came up as two edged sword for the US financial system.

Since mortgage loans were allotted on low margins, there were greater incentives for the sub-prime borrowers to default courtesy depressing house prices. Collective default by the borrowers led losses to financial institutions and investors alike. Although the loans were further securitized and sold to Specialized Institutional Vehicles(SIV), the losses were ultimately borne by the banks and financial institutions because of collective default by the borrowers and resulting in a big wipe off in their total capital. The whole process of securitization of mortgages was to achieve diversification of risk to those who can afford them. But when the crisis broke out it was found that the diversification was not received at all. What happened in practice was that risk was parcelled out increasingly among banks and financial institutions, and got effectively even more concentrated. It was interesting to know that the banks and financial institutions various stress tests before securitization of mortgages. The stress test revealed that the banks were well capitalized to deal with any shock. However, later it was found that such tests were based on the outdated data of the Great Moderation and did not properly capture and reflect the reality.

Thus, rising MBS demand contributed significantly to the housing bubble by ensuing proliferation of sub-prime mortgages from 2004 to 2006 . However, what was sowed in the whole process was the Financial Crisis of 2008.

iv) Underestimated Risk by Credit Rating Agencies

Credit Rating Agencies are said to be the gatekeepers in the financial world as through their regular and strict monitoring of various debt issue issued by government, corporations and securitization vehicles, these agencies issue credit ratings ranging from risk free to junk investment. Hence, the ratings issued by the credit agencies has a large influence over the decisions of the investors and the pricing and terms on which borrowers receive credit. However, Credit Rating Agencies were also blamed and were said to be a contributor to the financial risk. These agencies failed to evaluate the actual level of risk of the new structured products that contributed to the crisis by issuing AAA ratings to most of the sub-prime mortgage backed securities which were bundled into tranches by issuers. However, the methodology used in evaluating these issues, did not capture the sudden defaults in the US housing market, particularly from sub-prime mortgages. Later, when these securities ended up in losses with sub-prime mortgages defaulting on their home loans, it was clear that the credit rating agencies were not able to adequately evaluate the risk of newly structured products. Once it was found that even credit rating agencies contributed to financial crisis, its integrity was questioned by many market analyst. Since, credit rating agencies relies in fees paid by the issuers, it was argued that these agencies are manipulated by the issuing company’s management.

v) The Federal Reserve:

Yes, not only the banks but even the central bank was a big contributor to the financial crisis. Even federal reserve accepts that they initially they were not able to manage the financial crisis. Market analysts blame that the first mistake of the federal reserve was to led Lehman Brothers go bankrupt. However, there are other people who blame that the federal reserve made mistake much before than the Lehman Brothers bankruptcy, when it allowed the housing prices to increase for years and by tolerating the global current account imbalance. However, when everything was going un-noticed by the federal reserve, Lehman Brothers who relied heavily on sub-prime lending, went bankrupt after a glut of sub-prime borrowers defaulted on their loans. This allowed the panic to spread among the whole of the US economy and nobody trusted anybody and hence no one lended to any one. Suddenly, the cash flow was seized as everyone started hoarding cash for an emergency and this caused a seizure in the US economy. " We entered this crisis due to consumers spending more than they make," said Dr. Edwards. " Now it seems that our government is following the same practice."

Hence, not only banks, financial institutions, credit agencies, but even the federal reserve was a significant cause of the financial crisis.

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